NON-PROFIT COMPETITION

HEARING

BEFORE THE

COMMITTEE ON SMALL BUSINESS
HOUSE OF REPRESENTATIVES

ONE HUNDREDTH CONGRESS

SECOND SESSION

WASHINGTON, DC, JUNE 28 AND 29, 1988

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NON-PROFIT COMPETITION

TUESDAY, JUNE 28, 1988

House of Representatives,
Committee on Small Business,
Washington, DC.

The committee met, pursuant to notice, at 9:30 a.m., in room 2359-A, Rayburn House Office Building, Hon. John J. LaFalce (chairman of the committee) presiding.

Present: Chairman LaFalce; Representatives Sisisky, Olin, Hayes, Mfume, McDade, and Upton.

Chairman LaFalce. The Small Business Committee will come to order.

The Small Business Committee has scheduled these hearings today and tomorrow to discuss the issue of competition by non-profit organizations and by Government agencies with small business.

The issue of competition by non-profit organizations has become a major concern of the small business community in recent years because of the tremendous growth in the number of tax-exempt organizations and their increasing reliance on income-producing and other commercial activities. There are now about 870,000 non-profit organizations, more than double the number 20 years ago. Total revenues of the non-profit sector exceed $300 billion, accounting for about 6 percent of the Gross National Product.

The intensity of the small business concern about non-profit competition was reflected in the recommendations of the recent White House Conference on Small Business. Elimination of unfair competition by non-profit groups and by Government agencies was voted the third highest priority of the 1986 Conference.

The small business community believes that non-profit groups are entering commercial activities that are inappropriate and unrelated to the mission for which they are given tax-exempt status. They argue that the Federal income tax exemption, postal rate subsidies, and exemptions from other Federal and State government regulations give non-profits unfair competitive advantages in areas where for-profit businesses are providing the same goods or services.

Representatives of the tax-exempt community believe that their income-producing activities are a legitimate expansion of their exempt activities and provide an important source of income to compensate for the decline in their traditional funding sources—donations, dues, and Government grants. Many in the non-profit sector argue that the competition is more the result of taxable businesses entering traditional tax-exempt areas rather than an increase in commercial activities by non-profit groups.

We will hear other differing perspectives on the unfair competition issue during the course of these hearings to examine the nature and the extent of the problem of competition by the nonprofit sector and by Government agencies with small businesses.

The principal objectives of these hearings are first to identify the tax exemptions and other benefits to which non-profit organizations are entitled and to explore how these benefits provide a competitive advantage in the marketplace; second, to examine the reasons for the growth in the income-producing activities of the nonprofit sector; third, to identify the industries and the types of activities in which unfair competition by non-profit organizations and Government sources is perceived to have the greatest impact on small business; and, finally, to explore policy recommendations that address the unfair competition problem.

I am sure members of the committee know that the Ways and Means Subcommittee on Oversight has conducted a comprehensive review of the tax treatment of commercial and other income-producing activities of non-profit organizations. Chairman Pickle's subcommittee has made a valuable contribution to our understanding of the application of the unrelated business income tax, or UBIT, to the commercial activities of non-profits, and the underlying tax policy rationale for the tax treatment of those activities. I look forward to the subcommittee's policy recommendations regarding the UBIT, which are expected to be submitted to the full Ways and Means Committee this week.

Our hearings will also further our understanding of this difficult problem by reviewing the full range of Federal and State tax exemptions and other benefits accorded non-profit organizations and by examining the impact of these competitive advantages in specific industries.

Today's hearing will also explore the problem of direct Government competition with small business. OMB Director James Miller will discuss the implementation of current policy which requires Government agencies to rely on the private sector for goods and services when they can accomplish the same quality job at less cost.

We will have two panels of witnesses this morning. The first panel will be Government witnesses: James Miller, Director of the Office of Management and Budget; Frank Swain, Chief Counsel for Advocacy at the Small Business Administration; Jennie Stathis, Associate Director of the General Accounting Office; and Lorry Spitzer, Special Assistant to the Assistant Secretary for Tax Policy in the Treasury Department.

Our second panel will be academicians who have studied the problem of competition between the non-profit and for-profit sectors. They include: Richard Steinberg, Professor of Economics, Virginia Polytechnic Institute; Lester Salamon, Director of the Institute for Policy Studies, Johns Hopkins University; Dennis Young, Director of the Mandel Center for Non-Profit Organizations, Case Western Reserve University; and Peter Hall, Lecturer on Nonprofit Management, School of Organization and Management, Yale University.

Because of time constraints, however, we will hear first from the Director of the Office of Management and Budget, Mr. Miller. Prior to that, however, do any other members of the committee have any statements they would like to make at this time?

Mr. McDade. I don't.

Chairman LaFalce. Mr. Miller, please proceed.

TESTIMONY OF JAMES C. MILLER III, DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

Mr. Miller. Thank you, Mr. Chairman. It is a pleasure to be with all of you today.

This is an important issue, the interface between Government competition and private-sector competition. The assignment you have given me for today is to talk specifically about the A-76, "Performance of Commercial Activities" program of the Federal Government. This issue of the competition between Government and the private sector has had a long history. There was a House of Representatives report in 1932, and the second Hoover Commission in the 1940's flagged this issue as one of concern. There was congressional action leading in part to a Bureau of the Budget bulletin on competition in 1955 which set out basically the standards we have today, and that is that the private sector should be relied upon to produce goods and services of a commercial nature rather than Government.

The concept has been endorsed by every administration since 1955. The most recent statement in this regard is the 1983 OMB circular A-76. There was a follow-on Executive Order 12615 that was issued by the President in 1987 detailing specific timetables for an approach plan for following through on this business of reducing the amount of commercial products and services that are produced within the Government, by instead, having to contract for them with the private sector.

Since 1981, some 72,000 positions have been studied, resulting in some $696 million in estimated annual cost reductions, that is about $9,700 per position studied. Now, we find that the private sector wins about 60 percent of the studies with average savings of about 35 percent. But in the competition, the Government entity wins about 40 percent of the studies, and in those instances the average savings are somewhat less, about half that amount, some 17 to 20 percent.

Overall, when you do a study, you find that the cost is reduced an average of 30 percent. So just by studying positions, the taxpayer gains about 30 percent, whether it is the Government or the private sector that wins the bidding. Overall, there is about a 30-percent savings for taxpayers.

There is, in our program, a special recognition for small business. There is under the contracting competition a rule of two, there is a set-aside for small business—in the case of where there are two or more small businesses that could handle the program.

I would point out the average size of the A-76 study is less than 20 positions. We are not talking about something that requires the giants of the business world to accommodate, we are talking about something by and large that small business can compete with, compete for, and compete well.

I would point out, Mr. Chairman, and members of the committee, despite the problems we have had with the program we have only scratched the surface. We, and the executive branch, I think, can do a lot better. We think something like 800,000 more positions in the Federal Government could be competed with the private sector. Next year, fiscal year 1989, we plan to compete some 57,000 of these positions. It is about 3 percent of the civilian work force. In fiscal year 1989, in that budget, we docked the agencies some $238 million and 23,000 positions based on fiscal year 1988 A-76 studies.

However, our progress in this area is being impeded somewhat by constraints established by Congress, and I will mention two main areas. First, very frequently Congress has established employment dollars in agencies and in specific activities. In the testimony I think I cite the Veterans' Administration and Housing and Urban Development.

Second, there will be a controversial A-76 study and people will get to the appropriate committees of Congress, and there will be inserted in our appropriations language outright prohibitions on studying a particular activity for purposes of contracting out, and I think I mentioned fire fighting in the Department of Defense, and Custodial Operations at GSA. These restrain our ability to compete out activities of the Federal Government, and restrain the ability of small business to compete on a fair basis.

But more importantly, it seems to me, it restrains the ability of the taxpayer to realize the savings that are possible there. This program has great potential. We have, I think, only scratched the surface. What we need now is for us and the executive branch to move with greater boldness in this area. It seems to me that it would be useful also for Congress to facilitate rather than in some instances imposing impediments to our success.

Mr. Chairman, I ask that my full testimony with its attachments be included in the record, but I will stop here in order to be responsive to any questions you or other members of the committee might have.

[Mr. Miller's statement may be found in the appendix.]

Chairman LaFalce. How are non-profit organizations handled by an A-76 review?

Mr. Miller. They can compete. Anyone can compete. A Government entity from within or the private sector for-profit operations can compete, or even non-profits can compete. But when we do entertain the competition of non-profits, what we do is adjust their cost base as if they were a profit-making activity. We would adjust their base for taxes, they might pay for postal services that a commercial activity would pay in order to make the competition not only fair but to make the correct decision as to which of the entities would realize lower cost to the taxpayer.

Chairman LaFalce. Congressman McDade, any questions?

Mr. McDade. Thank you, Mr. Chairman. I don't have any questions. I would like to compliment the Director. I think he has given us an excellent overview of the circular that you sent out, and it is helpful to the committee in future deliberations. Thank you.

Mr. Miller. Thank you, Congressman.

Chairman LaFalce. Mr. Olin.

Mr. Olin. I have some questions to satisfy my curiosity.

I wonder whether this program of privatization has taken any kind of a pattern as to the types of work that you are finding that are the most likely to be resulting in savings? Could you give me just a little rundown on the types you have found most productive?

Mr. Miller. Let me indicate, Mr. Chairman, I apologize for getting my testimony up so late, I do have an attachment to the testimony, I hope the copies that you have include that attachment. Is there an attachment there?

Mr. Olin. I think not.

Mr. Miller. I am sorry. I will provide that information to you.

[The information requested may be found in the appendix.]

Mr. Miller. There is a very large variety of commercial activities. Data processing, for example, we found that is quite useful for us, also architectural services and engineering services. Another is technical management services, and housekeeping services, contracting out the maintenance of a building, repair of automobiles, photographic mapping services, and so forth, and also medical services.

Mr. Olin. Have you found, as a matter of interest, that the different departments have grasped this as an opportunity, or is it pretty slow going on their part?

Mr. Miller. Well, it is pretty slow going. Human nature being what it is, it is very—agency heads are reluctant to contract things out. I mean, the Federal Government is different from the private sector. In the private sector, if you are not efficient, you don't survive. It is human nature not to make the hard decisions for putting something up for contracting out so, in terms of the types of guidance OMB gives the agencies, we identified some potential areas for contracting out.

Of course, the employees are going to say, "That is impossible, we do as fine a job as anyone can do," and so forth, and I must tell you, managers in agencies are reluctant to say we are going to contract this out. We are going to study it. Even though if they are as efficient as they say they are, they will win the bidding. To contract it out is a difficult thing.

Let me tell you, I think the pressure ought to be brought to bear not only from us but from you on agencies to do a better job in this particular area.

Mr. Olin. I think most of us who have been in the private sector have found that the pressure of not having enough money is, of course, an incentive that the manager finally yields to, if, in fact, he believes privatization is going to result in savings.

Mr. Miller. Let me say we bend over backwards to be fair to the Federal employees because the employees are allowed to work with the manager in order to specify what the activity that is set out for bid might be. They have inside information. I don't mean that in a pejorative sense, but they know the operation very, very well, and then we give a 10-percent advantage to the in-house operation; in terms of the cost we will use in the final comparison.

I have had a lot of people in the private sector complain to me a bit earlier, why in the world—if we do it at lower cost, let us do it.

Mr. OLIN. Have you been able to protect the jobs of individual civil servants in terms of being able to move them out and into a different type of work so you don't result in laying people off?

Mr. MILLER. Absolutely. Under the A-76 program and other Federal employment standards, rules, regulations, statutory protections, when a program or an activity is contracted out to the private sector, the existing Federal employees have first option for slots in the private sector for this private entity that would be taking over the operation. They have right of first refusal in employment within the agency, within other agencies, they have all sorts of rights.

We, frankly, found the system works very, very well, and I was told yesterday, as a matter of fact, that the areas in which this program works the best are areas in which agencies have very active placement programs for their employees.

Let me say it is not only the A-76 program, but we are looking at Federal co-op types of programs where we would essentially encourage the Federal employees to set up their own little business that would take over the activity and perform it more cost effectively and return taxes to the Federal Government, pay taxes, and I think it is just a better operation.

Mr. OLIN. Thank you very much.

Chairman LAFALCE. Mr. Sisisky.

Mr. SISISKY. You said Federal employees have first priority for the jobs?

Mr. MILLER. Yes, sir.

Mr. SISISKY. Of course, in some of those jobs, you don't know that the salary differential is unbelievable. Particularly, in housekeeping, you could be making $7 or $8 an hour, and all of a sudden you go into the A-76 program, and it is $4.25 an hour. It has been my experience, anyway, that this has happened.

But you mentioned something else. I remember supporting this for a reason. You mentioned fire fighters in the Department of Defense. My district, with about a million people, is around more nuclear reactors than any place probably in the whole world. It has the largest naval shipyard, and they have nuclear reactors on those ships! I remember the argument over exempting fire fighters, and I tell you that I join the argument because if anyone was going to cheat, I am talking about in the private sector, it would cheat in training. A shipboard fire is far different from any other fire, particularly with nuclear reactors.

I just wanted to let you know, even though there were some of us who exempted fire fighters, that there was a deliberate reason.

But let's come back to the A-76. I didn't know we were going to get into A-76 today, to be honest with you. Have you followed through on all of the A-76 programs? I know I asked GAO to do a couple of studies, and they came back very well. There have been many people who say that a lot of people will buy into these programs and wait until the contract goes out. Have you found any of that in your experience?

Mr. MILLER. Let me say we monitor this very closely. I haven't personally reviewed all of these cases, but we are familiar with the buy-in strategy. But I don't think it works in the long run because anyone else can come in and offer to do the services as well or for less money, and we would certainly consider that. And there are opportunities for breaking contracts, you know, if you go in and find, for example, that you have a contract with a company and they are not performing the job, you can break those contracts, there is specific performance requirements in those areas.

Mr. SISISKY. Did I hear you say 800,000, you estimate 800,000 jobs——

Mr. MILLER. Positions.

Mr. SISISKY. How many Federal employees do we have?

Mr. MILLER. Well, you have about a million civilian employees in the nondefense area, you have about a million civilian employees in the Department of Defense, you have about two million in uniform, and you have about 800,000 in the Postal Service.

Mr. SISISKY. So we are talking about one-fourth, you think?

Mr. MILLER. A large potential, yes.

Mr. SISISKY. Thank you very much.

Chairman LAFALCE. Mr. Hayes.

Mr. HAYES. Thank you, Mr. Chairman.

I was late getting here, you see, and I didn't hear all the testimony. I just glanced through the prepared statement.

My main concern is when privatization is couched against the Government running its own operation, how many jobs are lost when changes are made. I have to use an example—and the number two issue, aside from job loss, is whether or not we really save the taxpayers money by privatization. I have seen instances where in order for a private entity to gain entrance into a particular area they bid low in order to do it, and once they get in, their motive is still the same, to get what they consider to be a decent return for the investment and the prices, sometimes the quality of products change, deteriorate.

We have a case in point here, and, Mr. Chairman, I don't want to digress too much, but we are very disturbed about the change that occurred here in the restaurant situation in the House. That has been privatized. And not only is it unfair to the people, because their security is in jeopardy who work there and not only that, the quality of the food——

Chairman LAFALCE. I am very concerned, too, that it hasn't been changed enough. We had the worst service in the world, now we have almost the worst service.

Mr. HAYES. I tell you, it is really something. It bothers me to no end, but my bottom line is that a number of people who work for a number of years giving good service stand to lose their jobs when it comes to privatization because of reductions in labor cost which usually result in people losing their jobs, some people.

Mr. MILLER. Mr. Hayes, could I respond to that in a couple of ways? Number one, I would just emphasize again that Federal employees under this A-76 program have a lot of rights of first refusal, and so forth, and we haven't generally found there is a particularly difficult problem. We don't see very many RIF's from this type of activity, the A-76 program.

And, second, if there is a loss of a job within the Government, there is a gain of a job on the outside. The question is sometimes there is not as many jobs on the outside as there were in Government, which is simply a reflection that the activity could be accomplished with less people.

But that is a gain for the taxpayer, and it seems to me we ought to be guided here by efficient government, by the principles of achieving whatever Government services are required at the lowest cost to the taxpayer. That ought to be our overriding goal. That ought to be the most important goal, and some of these other considerations are around the edges, but it seems to me that we owe, almost like managers owe to stockholders, we owe to the taxpayers to be as efficient in Government as we can.

Mr. HAYES. Except this so-called savings doesn't always reflect savings for the taxpayers. We have too many things going on now in Government that reflect the money may be saved, but used in the wrong way.

Mr. MILLER. We ought to nail anyone wasting Government money.

Mr. HAYES. I am waiting for that to happen.

Chairman LAFALCE. Mr. Mfume.

Mr. MFUME. I just arrived, I don't have any questions. I am still reading the testimony. Thank you.

Chairman LAFALCE. Thank you very much. Mr. Upton.

Mr. UPTON. I have no questions.

Chairman LAFALCE. Thank you, Mr. Miller.

The Small Business Committee will now hear from the rest of panel number one: Mr. Swain, Mr. Spitzer, and Ms. Stathis.

Frank, why don't you lead off.

TESTIMONY OF FRANK S. SWAIN, CHIEF COUNSEL FOR ADVOCACY, U.S. SMALL BUSINESS ADMINISTRATION

Mr. SWAIN. I think this committee is to be commended for devoting considerable time and attention to this very important and complicated subject, one that is very significant to small business, as your opening statement pointed out.

This issue, trying to rationalize, if you will, the relationship between the for-profit and non-profit community, was a top recommendation of the White House Conference. Competition by exempt non-profits with for-profit businesses is essentially Government-subsidized competition with the private sector, because to the extent the Federal Government subsidizes non-profit activity through the income tax exemption or lower postal rates or other legal exemptions that derive from State or local laws, non-profit commercial activity can be carried on with lower cost factors than the for-profit sector.

The Internal Revenue Code is the principal mechanism for balancing the need to encourage non-profit services with the advantage of exempt status, but it is our contention that this balance must be readjusted with legislative change, and further, that the Congress and this committee, in its examination of the issues, should look at some other Federal programs and some regulatory exemptions which may not continue to be necessary or relevant in a changing non-profit environment.

To try to summarize, as your statement pointed out, the Ways and Means Committee has been grappling with this issue, as far as the Tax Code is concerned, for well over a year now, and Mr. Spitzer will, I am sure, address some of the specifics there. The draft report that you alluded to, without getting into the specifics, really underlines two facts; that the increasing diversification of non-profit activities raises important tax policy problems—it is simply not an issue we can afford to ignore—and that statutory changes of some sort will be necessary to properly address the problems.

It is not just an issue the Internal Revenue Service can fuss with at an administrative level in order to solve the dilemmas facing us today. Unfair non-profit and governmental competition with small business is a public policy issue deserving of immediate attention and reform.

Your opening statement reflects some statistics that are also included in our report. It is clear the non-profit sector has grown, both absolutely in terms of numbers, and in terms of significance in the national economy, and Ms. Stathis' report underlines some of those issues as well.

In 1946, the not-for-profit sector received 41 percent of its support from dues, assessments, private contributions, and Government grants. In 1983, the proportion of support from that category was only 22 percent, which means, in effect, the non-profits are growing in economic significance, and the way they are financing that growth is basically through increased nontraditional revenues from sales and services, among other factors. Two-thirds of all the revenue derived by non-profits in 1983 was estimated to be derived from program service revenue, which includes related and unrelated business receipts.

I think it is important, when the committee is considering this, not to lose sight of the basic underlying rationale for why we, as a Nation and the individual States, grant a tax exemption to certain applicants. The principal rationale is that the tax exemption is granted to applicants because those applicants provide goods or services that are not otherwise publicly available. They would not be supplied in the absence of a tax subsidy or the other benefits flowing from exempt status.

Obviously, when not-for-profit organizations engage in activities which are clearly provided in the public sector, that rationale must be questioned. It cannot be used to justify an exemption for activities involving the goods or sales of services that are already available in the private sector.

Non-profits have, I think, significant competitive advantages. Outlined in our statement is what we feel the three or four principal ones are: First of all is tax exemption, and suffice it to say that there are a variety of laws relating to the taxation of not-for-profit institutions. The basic exemption from income tax is only part of the issue; there are a variety of related tax laws that affect the exemption from income tax. Congress has tried to deal with this over the years, but as we have said, it hasn't focused significantly on the issue since 1969, when the Ways and Means Committee started its hearings last year.

I would say the draft report by the Oversight Subcommittee was an important first step, but certainly not the penultimate solution to the problems raised at this point. It is a complicated set of issues, and we endorse a number of recommendations made by the Ways and Means subcommittee, but we think further work can be done. Further work can be done in the data-gathering area, and recommendations are currently under consideration by the IRS. Let me mention our statement includes the fact, of course, not-for-profits are exempt from tax but if they engage in certain sorts of commercial activities that are not deemed substantially related to their non-profit status, they have to pay income tax. That tax is the unrelated business income tax.

As your opening statement pointed out, the not-for-profit community has income in the hundreds of billions of dollars range per year. The total unrelated business income tax paid in 1985 was $30 million. In 1986, it almost doubled to about $60 million. In 1987, it almost doubled again to about $120 million. So from 1985 to 1987, the total amount of unrelated business income tax revenue went from $30 million to $120 million.

What does that suggest to me? Was there a four-fold increase in the amount of taxable activities over those two years? I don't think so at all. I think it illustrates the law is very murky and very, very ready for congressional intention to clear up some of the ambiguities in the law, because there are clearly not standards that tell either the for-profit competitors or the non-profit community what their tax status is in a number of activities.

The second major Federal program affecting non-profits is postal rate subsidies. Currently, there are no restrictions on the amount of advertising content which can be contained in non-profit third-class postage. Yet non-profit mail presorted enjoys almost a 50-percent reduction in mailing rate from for-profit, 5.3 cents per item opposed to 10.1 cents for for-profit.

Without getting into the exact mailing rates, I think it is important to point out that the Congress has attempted to push the Postal Service into lessening these subsidies for Federal budget reasons, and, in fact, there is a significant subsidy, $436 million, expected next year. That has come down from $650 million. But the way that this subsidy has been lessened is not by decreasing the overhead, in other words, decreasing the cost of the Postal Service, but by shifting the subsidy from a Government appropriated subsidy to a direct subsidy of for-profit third-class mailers to non-profit third-class mailers.

I suppose from a Federal budget standpoint, it is good the Federal budget isn't subsidizing as much anymore, but from the standpoint of the person paying the mailing costs it is just as bad. I think that is an issue the Congress will need to address itself to, because the tendency is locked in now for the Federal subsidies to decrease. From a Federal budget standpoint that is probably a good thing, but as the Federal subsidies decrease, the for-profits' subsidy of the non-profit increases, and I think tension will increase, and the Congress needs to take a closer look at that.

Attached to our statement is a list of other various exemptions and special treatments for non-profits. I think it is important to point out, as Mr. Spitzer does in his statement as well, a lot of what goes on at the State level is keyed to the Federal exemption, and in terms of dollars and cents, the State and local tax exemptions may be more valuable to the non-profits than the Federal tax exemption, in many cases. Until the Federal Government re-examines its treatment, the State and local governments may not focus on the issue.

I would like to summarize and finish up by suggesting from the small business perspective, there are two particular aspects of the issue that have been brought to our attention. One involves the increasing activities of health care related organizations, tax-exempt health care providers who engage in the sale of ancillary goods and services readily available from the for-profit providers. This is of significant concern. These activities commonly are not taxed because they fall under the exemption from UBIT for activities conducted primarily for the convenience of patients. For example, hospitals' operations of ambulance services, medical clinics, home health care, rehabilitation services have been found to be tax exempt. This is a real growth area, and one that is not clearly treated under the current tax laws.

The second sensitive area is the activity of universities and colleges on two fronts: One, in bookstores, which are the traditional area of complaint; and, second, university research activities, which are completely exempt from the unrelated business income tax.

As this committee well knows, and as you know, Mr. Chairman, because of your strong sponsorship of the SBIR bill, there is a very active and effective for-profit research community, but not-for-profit university research enjoys tax advantages that I think need to be clarified and reconsidered given the great growth in for-profit research and the great growth in technology in general.

To summarize, Mr. Chairman, this is a thorny, yet important policy area. I don't think anyone from the small business community approaches this with any interest in turning off the activity of non-profits so important to society. But I think there is a need to rationalize where those activities of non-profits have become essentially commercial in nature. Here we have to make sure the same tax, postal and other laws that apply to the commercial sector apply to the non-profit sector.

The committee can be of real service in taking a look at—not so much the tax issues, although those are clearly important—the variety of other issues and by attempting to make recommendations to the Congress on a number of fronts as to how this issue can be solved and how there can be some meeting of the minds between the small business community and the non-profit community.

Thank you, Mr. Chairman.

[Mr. Swain's statement, with attachment, may be found in the appendix.]

Chairman LaFalce. Our next witness will be the Special Assistant to the Assistant Secretary for Tax Policy, Mr. Adelbert Spitzer.

TESTIMONY OF ADELBERT L. SPITZER, SPECIAL ASSISTANT TO THE ASSISTANT SECRETARY, TAX POLICY, DEPARTMENT OF THE TREASURY; ACCOMPANIED BY ELLEN APRILL, ATTORNEY/ADVISOR

Mr. Spitzer. I am pleased to have this opportunity to present the Treasury Department's views concerning the question of competition between tax-exempt organizations and taxable businesses, particularly small businesses. I am joined today by Ellen Aprill, Attorney/Advisor in Treasury's Office of Tax Policy.

My testimony today will focus primarily on the unrelated business income tax, the rationale for income tax exemption and the effect on competition on income tax exemption and other subsidies. In addition, I will offer several suggestions as to how the interests and expertise of this committee can best be used to address the issue of competition between tax-exempt organizations and taxable businesses.

Prior to 1950, under the so-called destination of income rule, the majority of courts had held that a tax-exempt organization did not lose its tax exemption by virtue of the conduct of an unrelated business so long as the profits from that business were dedicated to charitable purposes. In fact, a feeder organization that engaged exclusively in commercial non-exempt activities was treated as exempt from tax so long as all the profits from the organization were distributed to an affiliated charitable organization.

In 1950, Congress responded to the operation of unrelated businesses by exempt organizations by enacting a tax on such organizations' unrelated business income. The legislative history of the Revenue Act of 1950 indicates that Congress was concerned primarily with the issue of unfair competition and believed that such unfair competition existed at that time because exempt organizations were able to use their profits tax free to expand operations while their competitors could only expand with the profits remaining after tax.

Although the unrelated business income tax, the so-called UBIT, now applies to virtually all tax-exempt organizations, very few exempt organizations, in fact, report liability for the tax. In fiscal year 1985, for example, only about 3 percent of all tax-exempt organizations filed form 990–T in order to report unrelated business income.

As Mr. Swain indicated, the amount of unrelated business tax revenue, however, has increased sharply during the past several years, doubling three times from 1985 to 1988. This rapid rise in the UBIT revenue has likely resulted from a combination of factors, including increased compliance, which is certainly at least in part due to the recent congressional scrutiny of UBIT and increased unrelated business activity.

Allow me now to turn briefly to the rationale for tax exemption as we view it at Treasury. Although private charities are privately operated and controlled, their exempt activities are restricted to those deemed to serve the general public interest. An organization that provides food and shelter for the poor or that encourages education, the arts, or humanities, is serving the same general purposes with which Government itself is concerned. Thus, money donated or paid to such organizations for the purpose of carrying on their exempt functions may be viewed as similar to funds transferred to and used for the general purposes of Government. Although this rationale for exempting public charities and their activities from taxation remains as strong today as when the income tax was first enacted, limits on the scope of such tax exemption are both appropriate and necessary.

This Nation has prospered through its reliance on a private market-based economy to supply necessary goods and services. The role of Government generally has been restricted to those socially important activities not adequately supplied by the private sector. The role of the quasi-governmental, tax-exempt, private sector should similarly be restricted to that of supplementing and not supplanting the activities of for-profit businesses. Thus, tax exemption for public charities should be restricted to those areas where the quality or quantity of goods and services that would be produced strictly through market forces is deemed inadequate.

Turning now to the question of exemption, it must be emphasized that even with increased restrictions on the commercial activities of tax-exempt organizations, all competition between exempt organizations and taxable businesses cannot be eliminated without repealing the tax exemption for many non-profit organizations.

Competition between taxable and tax-exempt organizations is of particular concern, however, and must be scrutinized carefully, when the goods or services provided by the exempt organization is further removed from the organization's core purposes. We may not be concerned, for example, that a university's tax exemption extends to the sale of textbooks through the student bookstore since the product, textbooks, is essential to the school's educational function and may be irregularly or incompletely supplied by private businesses.

If the same student bookstore, however, also sells clothes, appliances, and other consumer goods, the activity moves further from the university's educational function and involves products which, in general, are amply supplied by the private sector. Extending the university's tax exemption to these sales may displace taxable businesses in an area where private markets are working effectively.

There is little evidence regarding the effects of tax exemption with respect to competition between exempt organizations and taxable businesses. Nonetheless, it seems clear that when tax exemption is combined with other governmental subsidies, many of which were noted by Mr. Swain, such as the ability of some exempt organizations to issue tax-exempt bonds, access to lower postal rates, exemption from certain Federal excise taxes, and exemptions from certain State and local taxes, an exempt organization's cost of producing goods and services for sale is reduced in comparison to the costs of its taxable competitors. Consequently, there exists an incentive to produce such goods and services rather than for the exempt organization simply to make passive portfolio investments, which are also exempt from tax.

The result of this incentive is that exempt organizations may be able to either expand more rapidly than their taxable competitors or to reduce prices below those sustainable by their competitors. I would emphasize, however, that because current evidence is primarily anecdotal, it is difficult to draw broad conclusions from the data we have available today.

In our testimony before the Ways and Means Oversight Subcommittee last month, we commented on a group of discussion options released by Mr. Pickle's subcommittee. We testified in support of a number of these discussion options, some with certain modifications. Allow me to summarize very briefly what those discussion options were that we supported.

First, the options would provide special rules in several areas, generally tightening up current law and providing a bright line test for taxability. These areas include museum shops, and college bookstores, medical equipment sales, fitness facilities, travel and tour services, some food sales, veterinary services, hotels, affinity credit cards, and advertising.

Second, the options would repeal the so-called convenience exception under which unrelated businesses operated for the convenience of members, students, and so forth, are exempt from tax.

Third, the options would modify the UBIT exemption for royalties in order to distinguish active from passive royalties.

Fourth, they would increase the nontaxable amount of unrelated business income from $1,000 to $5,000. This is a floor up to which exempt organizations pay no tax on unrelated business activity.

Fifth, the options would modify the definition of a controlled subsidiary and apply new rules to payments from such a subsidiary.

Sixth, the options would aggregate the activities of exempt organizations and certain controlled subsidiaries for purposes of applying the so-called primary purpose test, which is a test used to determine whether an exempt organization is eligible to retain its exempt status, in other words, asking whether or not its primary function has perhaps ceased to be its exempt purpose but has become one of unrelated business.

Seventh, the options would revise rules for allocating expenses between exempt and taxable uses of property.

And, eighth, very importantly, the options would expand reporting to the Internal Revenue Service and mandate the completion of certain studies by Treasury and IRS.

In addition to supporting these relatively discrete changes to the UBIT being considered by the Oversight Subcommittee, the Congress should undertake a broad review of the rationale for tax exemption in order to ensure that the substantial benefits of tax exemption are appropriately limited. Such a review would enable Congress to determine whether the current categories of exempt organizations and the basic rules regarding unrelated business taxable income are appropriate when applied to the tax-exempt sector of our modern economy, a sector that is undeniably much changed and has become increasingly dependent on commercial income since the earliest rules regarding tax exemption were adopted by the Congress.

This kind of comprehensive review would require collection of improved data regarding the scope of commercial activities being conducted by such organizations and the effect of those activities on taxable competitors.

To conclude, allow me to make three relatively simple recommendations as to areas where I believe the expertise of this committee could be usefully brought to bear.

First would be to encourage better coordination of Federal, State, and local actions. The question of the appropriate scope of tax exemption and other governmental subsidies has been sporadically reviewed at the Federal, State, and local levels during recent years. Several localities, for example, have recently challenged the real estate tax-exemption of non-profit hospitals. It would be helpful if a more coordinated review were undertaken. In particular, an effort should be made to quantify in a systematic manner the types, amounts, and allocation of governmental subsidies provided to various categories of exempt organizations.

Second, further analysis of unfair competition should be undertaken. As noted above, there is little conclusive evidence regarding the competitive effects of tax exemption and other governmental subsidies. The issues should be studied in greater detail utilizing improved data the IRS intends to collect, as well as data collected by other governmental agencies and by private organizations. It would be helpful, for example, to analyze particular industries in which the balance between taxable and exempt firms has changed over time.

Third would be to encourage improved cooperation between taxable and exempt entities. In many instances the problem of unfair competition could be reduced or even eliminated by increased cooperation. Taxable businesses could be encouraged to work with exempt organizations so that exempt organizations can make profitable use of underutilized facilities and other assets without becoming directly enmeshed in the operation of a business.

We believe this committee is well situated to encourage this form of mutually beneficial cooperation. The Committee on Small Business serves an invaluable function in providing a forum for the concerns of small businesses. Such concerns are of the utmost concern to those of us involved in the formulation and administration of the unrelated business income tax. We welcome your assistance in identifying problems and in formulating solutions in this important and difficult area.

This concludes my prepared remarks, and, at the end of the panel, I would be happy to respond to your questions.

Chairman LAFALCE. Thank you.

[Mr. Spitzer's statement, with attachments, may be found in the appendix.]

Chairman LAFALCE. Our next witness is Ms. Jennie Stathis, Associate Director of the General Government Division of GAO.

TESTIMONY OF JENNIE S. STATHIS, ASSOCIATE DIRECTOR, GENERAL GOVERNMENT DIVISION, U.S. GENERAL ACCOUNTING OFFICE

Ms. STATHIS. Thank you, Mr. Chairman.

I am pleased to be here to participate in your hearing. I would like to summarize my statement and submit it for the record. Our statement is based on a 1987 report which we issued on this issue. Our report showed that competition has become a major concern to taxable business and tax-exempt communities because they are increasingly providing similar services. My statement highlights two major points.

First, it discusses the incomplete data that are available on the subject, but then shows what data are available and what they show.

The second point gets into the views of the two sectors on competition and summarizes the results of a survey we conducted in six industries in 1986.

On the first point, IRS routinely collects tax returns and other such data on tax-exempt organizations, and these data are generally regarded as the best available. But the data do not encompass the entire tax-exempt community, and do not identify the type, the specific nature, or the extent of income-producing activity.

What data there are indicate that the tax-exempt community has grown significantly in terms of the number of organizations and the types of activities, and this growth alone could be the source of some of the concern that you may be hearing from the business community. As the statistics that have been used before here show, the numbers of tax-exempt organizations have increased about 100 percent in the last 19 years. The number of activities in which they participate has increased about three-fold, and a number of tax-exempt organizations participate in more than one of those activities. So clearly, there are a wide variety of activities in which they are participating.

The data also show the tax-exempt organizations have become more reliant on income-producing activities and less reliant on support from contributions, or Government grants, or dues. And as a result, some organizations now impose fees for services related to their exempt purpose which they previously provided at little or no cost. They are also expanding services to new markets and operating income-producing activities either related or unrelated to their exempt purposes.

The tax-exempt community attributes this shift in funding sources in part to a reduction in Government support and the inability of their other traditional funding sources, such as contributions, to compensate for this reduction. So this has led to instances where some tax-exempt organizations are competing with taxable businesses to provide similar services.

In terms of our second point, views on competition, we solicited the views of representatives of selected tax-exempt organizations and taxable businesses to get their perspectives on the competition issue and not unexpectedly their views differed. Tax-exempt organization representatives told us that income-producing activities further their exempt purposes and are important to generate needed additional revenue to fund their activities. They believe that competition is the result of taxable businesses increasingly entering traditional tax-exempt activities, such as day care or physical fitness. On the other hand, taxable businesses told us that these income-producing activities have exceeded the traditional role of tax-exempt organizations and that their tax exemption affords them a competitive advantage.

To get a little more specific information on this issue, we sent a questionnaire in 1986 to more than 1,700 randomly selected businesses in six industries. They were: Audio/visual, racket sports, research and testing, tour, travel, and veterinarians. Not having any other basis from which to start, we selected those particular industries by examining the letters of complaints about competition that Mr. Swain and the Small Business Administration had received.

These were the six types of businesses that had been voicing the most complaints.

And from that survey we concluded a number of things. First, a substantial number of businesses in each of those industries reported experiencing competition from one or more tax-exempt competitors during the years 1980–85. This ranged from a low of 45 percent of travel businesses to a high of 90 percent of racket sports businesses.

Second, a majority of those businesses that reported experiencing competition thought it was increasing.

Third, the primary type of tax-exempt competitor varied by industry. As Mr. Swain has referred to, several of the businesses pointed to public universities as a source of competition.

The fourth point made by respondents was that tax-exempt organizations have an advantage when competing with taxable businesses, and they cited the following items: The exemptions from Federal, State, and local taxes, the availability of grants and free facilities, reduced mailing rates, voluntary labor, and the erroneous belief of some taxpayers that amounts remitted to tax-exempt organizations for goods and services are actually deductible as charitable contributions.

As you might expect, the extent to which these factors were considered advantageous varied among the six industries we surveyed.

The fifth point was that over half of the taxable businesses in each of the six industries reported that the presence of tax-exempt competitors decreased profits for their businesses and reduced a potential market. Many businesses also cited tax-exempt competition as necessitating price reductions on their part in order to remain competitive. A smaller number of businesses reported tax-exempt competition resulted in layoffs or other curtailment of activities.

I should note for you these responses represent the views and perceptions of businesses in those six industries. We have no idea whether they necessarily represent the entire taxable business community, and we also did not attempt to develop any empirical data that would support their perceptions. So they are just that, they are perceptions.

I would conclude by saying that we do believe this is a problem; but because of the nature in which data are now collected, it is really difficult to quantify the nature, the extent, or the effects of it between the two communities. I will conclude my statement with that and be happy to respond to your questions.

[Ms. Stathis' statement, with attachment, may be found in the appendix.]

Chairman LaFalce. Thank you very much.

I won't take too long. We will give the other members of the committee an opportunity to question you.

It surely seems to me that all of you are in accord. We have a tremendous dearth of data, do we not, and therefore it is difficult to understand the extent of the problem, assuming that there is a problem, and it is difficult to come up with public policy responses to it.

What should we do to explore the depth of the problem, the breadth of the problem? Should this be done by Congress, should this be done by the executive branch, by the——

Ms. STATHIS. Are you asking for my response?

Chairman LAFALCE. I am asking for all of your responses, yes.

Ms. STATHIS. I think I agree with Mr. Spitzer, that the provision that is currently in the UBIT proposals before the Ways and Means subcommittee will help a great deal in terms of asking IRS to collect more data than they currently do. I think that will be a big start.

Chairman LAFALCE. Is that enough, just have the IRS collect more data?

Mr. SWAIN. I would add my agreement to that, Mr. Chairman. In our office, as you know, we operate an economic research program, and we have for two years issued RFP's and asked for proposals to study this. We funded no proposals last year. The current proposals are under review, but I am informed by my staff the recommendation may well be not to fund any proposals this year.

Chairman LAFALCE. You didn't think any responses were adequate to the task?

Mr. SWAIN. Methodologically not adequate to the task——

Chairman LAFALCE. I am delighted to hear you didn't fund them.

Mr. SPITZER. I would emphasize that although there is agreement that data collection is important, that is not the end of the problem by any means. We believe in the tax area that where information and data are adequate to understand some of the problems that exist with the current statutory provisions, Congress could reasonably act in a relatively limited and discrete manner as reflected in the Oversight Subcommittee's discussion options. A comprehensive review would have to await better data.

Chairman LAFALCE. What changes in forms, Mr. Spitzer, would be required in order to collect the type of data that would be relevant and meaningful?

Mr. SPITZER. At Treasury, we are currently working with the IRS to try, even prior to a congressional mandate in this regard, although that would be certainly helpful, to improve both the form 990, which is the standard information return filed by exempt organizations, and the form 990-T, which is the form for reporting unrelated business income. I think probably the most significant detail that should be brought out better in the forms is to break down the precise business activities that are engaged in by exempt organizations.

For example, by using industry codes that would provide some kind of uniform method for assessing what businesses exempt organizations are, in fact, engaged in, whether or not the businesses are related. Simply a full statement of what those businesses are, together, to the extent possible, with some identification as to why those particular businesses are being treated as substantially related, if, in fact, they are reported in that manner. I think that will give all of us a better idea of both what is going on currently and what arguments are being made as to why activities are substantially related.

Again, the substantially related test is the test that allows business income to be exempt from tax if that business is substantially related to the exempt purpose of an exempt organization.

Ms. STATHIS. I would agree with that. We have found often a tax-exempt organization provides information to the IRS when it applies for tax-exempt status and may not subsequently provide any additional information. And some of these organizations received tax-exempt status many years ago, so there really is not a lot of current data.

Chairman **LaFalce**. They may have been exempted 20 years ago.

Ms. **Stathis**. Sure.

Chairman **LaFalce**. This is just an interesting aside, but somebody made the statement about how some individuals would claim a deduction for something for which they received value. I forgot which one of you made that statement.

Mr. **Spitzer**. That is a concern of Treasury's. When we testified last May, we had indicated to the Oversight Subcommittee that we think this is an area where, although hardly huge dollars of tax abuse but probably lots of small cases, where somebody buys a Christmas tree or Girl Scout cookies, or whatever, and takes a full deduction for the purchase price when, in fact, something of value is received. We think it is important that contributors be made aware of the fact that a charitable contribution deduction is limited to the difference between the amount paid and the value of what was received.

Chairman **LaFalce**. I know of a number of instances, a great many instances, where there are grammar schools, high schools, colleges, TV stations, that might have raffles, auctions, and so forth, you have to bid on something, you might pay $100, and you get something of value for $100, $150, or $200. I assume some individuals might even take a deduction. Sometimes it is even advertised that you can take a deduction.

What policing mechanisms do you have for that, what enforcement mechanisms do you have for something like that, if any? Or do you think it is too insignificant a problem?

Mr. **Spitzer**. I wouldn't say it is too insignificant. In terms of dollars, it is probably more than an insignificant amount. It creates a perception of widespread cheating going on, and it lessens respect for the tax system when you see your neighbor taking a deduction for not just raffle tickets, but for school tuition, for example. A check is made out to a tax-exempt organization. So, again, I think it is a serious issue and one that ought to be addressed. Something can be done; in fact, the Internal Revenue Service was charged by Congress last year——

Chairman **LaFalce**. How do you do that? I write out two checks, one specifically for tuition and one specifically for charitable contribution, the same entity, but how do I distinguish that?

Mr. **Spitzer**. On its face there is no way to distinguish the two. It is obviously a self-assessment tax system where you would expect that the individual writing the two checks would only take a charitable contribution for what amounted to a contribution. An auditing agent would inquire whether or not any goods or services were received in exchange, but problems of proof are very difficult.

One idea that has been floated is to require different kinds of payments be made to different funds within a tax-exempt organization so a payment to a school for tuition, for example, could be made to a fund that indicated it was not a charitable contribution.

Chairman **LaFalce**. No further questions. Mr. McDade.

Mr. **McDade**. Thank you very much, Mr. Chairman.

Let me first of all thank all of you for your testimony, which was very well presented. It will be a big help in the committee's deliberations. I wanted to kind of get the question to all of you. I am trying to get a feel for the scope of the problem we are talking about. I am trying to get a feel for that in terms of taxation that might be evaded, ought to be collected. I am trying to get a feel for it in revenue foregone in the postal bill which may be foregone, I am trying to get a feel for special treatment perhaps of facilities, and so forth, that might enable a non-profit where you would be contending there ought to be some kind of tax to go into a facility.

Do we have a parameter of the world we are talking about in terms of either expenditures by the Treasury in forms of tax concessions or the contrarywise, something like revenue for nonappropriated money out of the postal bill? Do we have any kind of universe we are talking about?

Mr. SWAIN. I can address the postal issue because we checked the appropriations records in preparing the statement, and it has been in the range of about $.5 billion per year. As I mentioned, that is the Federal subsidy which is shifting. Within the mailing system itself now, the Postal Service is being——

Mr. MCDADE. We have that number, and we heard your testimony that is being shifted from an appropriated dollar to a back-in dollar tax on the industry.

Mr. SWAIN. That is right.

Mr. MCDADE. What about Treasury, do you have any kind of feel——

Mr. SPITZER. For several reasons it is difficult to put a dollar figure on this, because a lot of this is a definitional question as to what the scope of——

Mr. MCDADE. If I were to ask you for a horseback estimate of what we are talking about, and I realize it is a horseback estimate, because the first series of questions were that we lacked data really to attempt to get at the problem. They used to tell us in law school, if you don't know, you should give an answer based on a horseback estimate. I am asking you for not really a fixed figure but to just try to get a feel for it. What does it look like?

Mr. SPITZER. Current UBIT collections are $120 million; there is some indication that the reporting is not particularly accurate by exempt organizations.

Mr. MCDADE. You used a devastating figure of 3-percent compliance.

Mr. SPITZER. It would be a mistake to suggest it is 3-percent compliance, because it may be only 3 percent of exempt organizations carry on any unrelated business activity. This is a relatively concentrated problem with only a few organizations as to noncompliance. Roughly a third of UBIT collections come not from the original filing of the return but from audit activities, and that is substantially higher than you find in either of the individual or corporate sectors.

Mr. MCDADE. It looks to you it might be a problem created by definition, or whatever, of people reporting under that section.

What does that lead your horseback opinion to be, a parameter of what the issue might be as to dollars? I am talking about lost revenue, and I know that is difficult because we don't have the data, but I am trying to get a feel for the universe.

Mr. Spitzer, when I get a question like that up here on the Hill, I ask for permission to revise and extend my remarks, if the chairman doesn't object to revising and extending at any time. It is a free-floating figure, we understand that.

Mr. **Spitzer**. A current IRS study, in fact, is being undertaken to try to get some sense as to what the tax gap is. I would say again, given that current collections are roughly $120 million, and that self reporting is sometimes off by as much as a third, that under current law, perhaps half as much again of the $120 million might be collected again without revision.

Mr. **McDade**. You think maybe a quarter of a billion dollars, somewhere in that range?

Mr. **Spitzer**. One-hundred-twenty million dollars being current collections, maybe as high as $200 million, roughly. That is a jumping horseback estimate.

Mr. **McDade**. I understand, subject to revision.

Ms. **Stathis**. Mr. McDade, I took your question to be a little broader, not just what might additionally be collected in UBIT, but what might be lost from the Treasury in terms of unwarranted charitable deductions, as well as the total tax expenditure from affording this tax exemption.

Mr. **McDade**. That is exactly where I want to get to.

Ms. **Stathis**. I think Mr. Swain, in an earlier hearing at which we appeared, recommended that we start estimating the tax expenditure in this area, which I think is a good suggestion, but it is not currently done. And given the lack of information that we have on these organizations, it would be very difficult to do until some of that data is collected. So I don't think anyone really knows the answer to your questions.

Mr. **McDade**. I am sure.

Mr. **Swain**. I was going to add, as you know, that under the Congressional Budget Act there is a required listing in the annual budget analysis of tax expenditures; how much does a certain depreciation system cost? There is currently no analysis published of the tax expenditures of any part of the tax-exempt community. It has just been, by historical practice as much as anything, excluded.

Mr. **Spitzer**. To try to give the broader answer that Ms. Stathis had——

Chairman **LaFalce**. That is an area to pursue on the part of the Congress.

Mr. **Spitzer**. As I understand the tax expenditure budget, I believe charitable contributions are included in that.

Chairman **LaFalce**. That is not an exemption.

Mr. **Spitzer**. I believe it is viewed as a definitional question, and part of the normative tax system, and consequently not included in the tax expenditure budget.

Mr. **McDade**. Do you happen to know what that is listed as?

Mr. **Spitzer**. For charitable contributions? I don't know.

Mr. **McDade**. It is an enormous sum, I am sure.

Mr. **Spitzer**. We could easily find out. For fiscal year 1988, the tax expenditure budget shows a revenue loss of approximately

$13.5 billion because of the deductibility of charitable contributions.

Mr. McDade. Let me ask you a question while we are in that particular thicket. We are talking here about non-profits and whether or not they might be engaging unfairly in competition with the private side because of the Tax Code. Should we talk only about non-profits? Is there anything else in the universe we should talk about? Are there foundations, for example, that are treated differently we should talk about?

Mr. Spitzer. Private foundations are included——

Mr. McDade. Is there anything else we should be looking at?

Mr. Spitzer. The only point I would make that you didn't mention is competition with the governmental sector as being part of this.

Mr. McDade. What do you mean by broad review?

Mr. Swain. The sort of thing that Director Miller was addressing. I mean the issue of when the Government——

Mr. McDade. Contracting out?

Mr. Swain. Contracting out.

Mr. McDade. OK. We did cover that. I want to make sure in the viewpoint of the people at the table there is nothing out there we shouldn't be including. I want to make sure we cover that.

Mr. Spitzer. I think you defined the universe well. It is a broad universe.

Mr. McDade. Does everyone agree the purpose of the 1950 act, whatever it was, that set up special treatment of non-profits, the rationale is to promote social and other types of activity in the country that can best be done by non-profits, and that is the reason to encourage that as a matter of public policy?

Mr. Spitzer. That is our view as to what the rationale is, and it is reflected in that act. It is not explicit in the legislative history, however, that kind of policy definition.

Mr. McDade. It is not?

Mr. Spitzer. No; the legislative history of the 1950 act simply refers to the reason for enacting the UBIT, simply assuming that if an organization doesn't pay tax, it can expand more quickly than its taxable competitors.

Mr. McDade. Do the subsequent dealings with the UBIT or any other sections of the Code that apply indicate that the paramount reason for dealing with the issue is so that we are sure we promote public policy objectives that provide non-profit production of services that might otherwise not be met? That is the social purpose for the provision of the Code?

Mr. Spitzer. It has been fleshed out during the last few years in testimony before——

Mr. McDade. There was no more rationale than that one?

Mr. Spitzer. Excuse me? There is none.

Mr. McDade. Is there another rationale?

Mr. Spitzer. That is the primary one.

Mr. McDade. If there are secondaries, what would they be, secondary reasons for public policy?

Mr. Spitzer. In some cases there are historical reasons for activities being tax exempt. In some cases, mutual benefit organizations, such as social clubs, are not per se, something the Government wants to encourage but they are not viewed as appropriate activities to subject to an income tax.

Mr. McDade. Would they be the two?

Mr. Spitzer. I believe those are the two primary ones.

Mr. Swain. I might add a third, Mr. Chairman; that is what is called a quality assurance rationale which is most frequently applied to the medical community. The consumer doesn't have a knowledgeable choice of medical services. When he breaks his arm he can't waste time deciding who is going to give better services.

Therefore, some parts of the medical community enjoy a tax exemption because it is going to deliver service first and profit second. I think that the medical community has evolved significantly and we have a mixed system of for-profit and not-for-profit. There is a very vigorous debate within the medical community as to whether the non-profit medical community provides a greater degree of charitable services and, of course, questions about quality are always very subject to debate.

Mr. McDade. Mr. Chairman, thank you very much.

Chairman LaFalce. Mr. Olin.

Mr. Olin. Thank you, Mr. Chairman.

I want to make a couple observations. First of all, I want to say the presentations were very provocative and to a considerable extent quite useful—maybe.

And the reason I say that is that it is evident, I am sure you know—you feel this way when you think about this subject—it is an extremely complicated subject.

It is not easy—it doesn't lend itself relatively easy to simplification and it is not easy to define what a non-profit should be. You can't even define what non-profit is, I don't think, for sure. Let me ask you that.

What is the definition of non-profit?

Mr. Spitzer. The name itself is almost a misnomer because it suggests such an organization cannot seek to earn a profit. It has been suggested a more appropriate name would be, rather than a non-profit constraint, that they have a distributional constraint—simply that the organization can't be operated in a manner to pass on profits to private individuals in their private capacity.

Mr. Olin. It is a question of what you do with the money left over.

Mr. Spitzer. That is correct.

Mr. Olin. Not whether you have it or not.

Mr. Spitzer. Right. They are perfectly free to make a profit. It is just who it goes to.

Mr. Olin. Of course, the question of whether goods or services are not otherwise available, that is almost impossible to find out and it is a constantly changing thing. It changes over time, changes by people's whims, it is always changing. So when you give an organization the category of tax exempt, it only really fits for one particular evaluation at a particular point in time and at a different time it may not be logical anymore.

So when you say that, gee, we ought to analyze this, get more data, find out how to fine-tune our decisions, you are to some extent I think asking for the impossible, and you might really better direct your activities at how could we simplify this whole thing so we don't have to make so many of these small distinctions.

And I wonder whether you could comment on—it is probably heresy to even bring up the subject—but is it possible we should have vastly fewer tax exempt organizations where you just don't have that problem anymore?

When you think about hospitals, for example, we have for-profit hospitals, we have not-for-profit hospitals and I have quite a few of both types in my district. I will be darned if I can tell the difference between them, really. One difference is the non-profits don't pay dividends, but in terms of the operation of the hospitals, their ability to expand, their ability to compete, it is pretty hard to draw the distinction and each one, each of these hospitals makes its own choices as to what different businesses it will be in, how much money it gets in contributions, how much money it gets from other sources, and certainly all of them tend to compete with other medical facilities, laboratories, and home care, there are all kinds of problems.

Is it possible that we should be looking at the basic definition of—not necessarily non-profit—what should be tax exempt? And try to really minimize the number of categories, tighten up the definition?

Is that a direction that you think is worth exploring?

Maybe you, Mr. Spitzer, could answer first.

Mr. SPITZER. We think the subject is certainly worth exploring and is a review we have recommended Congress undertake. I am not sure the ultimate goal would be reducing the total number of exempt organizations but anything that could be done to simplify the structure——

Mr. OLIN. It would be to simplify and avoid this basic concept you are talking about which is the exception between the tax advantaged institution against a small business, a business that doesn't have any tax advantage at all.

Mr. SPITZER. Let me——

Mr. OLIN. Wipe out the number of instances where that is bound to be occurring.

Mr. SPITZER. One problem is that the entire range of economic activities in this country are often affected by both the exempt and taxable sectors. You alluded to the health care sector and that in particular is such a significant part of the whole tax-exempt structure that it really presents unique issues; issues that I think warrant studies on their own.

Mr. OLIN. You say study—study industries, study health care, study higher education.

Mr. SPITZER. That is right. For example, to stay with health care just a moment, if the Government chooses to subsidize health care as an activity, it ought to think perhaps as to whether or not there is some way to provide uniform subsidies to all hospitals. Be that some modification of tax exemption or whatever, but that is the kind of thing that does warrant some consideration.

You have well pointed out we could have all the data in the world and the hardest questions are still sitting there. We know what the hard questions are now and many of the questions won't be easier even when the data is collected. How do you define those activities?

Mr. Olin. We also know the tax code keeps getting more and more complicated and no matter what we try to do with it, it gets worse.

Mr. Spitzer. It would seem almost irreversible. There are currently 25 categories of exempt organizations. It presents problems.

Mr. Olin. Anyone else have any comment on this area?

Mr. Swain. In the health care area, one could always take the approach the Ways and Means Committee took with Blue Cross about two years ago. In general, Blue Cross is a not-for-profit health insurer. The question is: How are they different than Travellers, Aetna, or the for-profit companies that sell health insurance?

The Ways and Means Committee, Mr. Spitzer, and others who are better tax technicians than I, could better describe it, they said in effect: All right, Blue Cross, you are really different than you were back in the early thirties when you were formed as a mutual health insurance organization and there weren't any other health carriers. Times have changed and the product you offer is not intrinsically different than the product offered by Aetna, and so on. Blue Cross argued, we still do important charitable things. The Ways and Means Committee basically said, all right, to the extent that you engage in charitable activities, we will give you a super deduction for that, but for all your standard business, we will treat you just like a for-profit health care facility.

So then I would characterize that as sort of a results outcome, to the extent that the application to hospital situations, all hospitals would be treated similarly taxwise. If in some hospital, 99 percent of their patient days were for-profit, they would have a 1-percent deduction, but if in the catholic hospitals, 93 percent were for-profit, they would get a larger deduction to encourage that.

That is the results outcome approach the Ways and Means Committee took with Blue Cross, and in effect it addresses the issue instead of gumming up a tax code to look further at the delivery mechanism.

It is fairly easy to figure out how many were free and how many were for-profit. For other things, like educational institutions, it is a little more of a challenge.

Mr. Olin. Ms. Stathis, do you have any comment on that?

Ms. Stathis. I would just add, GAO did the Blue Cross/Blue Shield study for the Subcommittee on Health of the Ways and Means Committee, and we did an earlier one on electrical cooperatives using the same type of approach. Looking at particular businesses and doing an analysis of them, you may be able to come to some reasonable conclusion; but there are so many types of organizations that you might have a difficult time. I would also add the point that I think the tax-exempt community would tell you, as they told us, that they feel that their tax exemption should not be affected by new entries into their fields, that their tax exemption was agreed upon at a point in time when they were providing a needed service.

So you would encourage that kind of reaction if you were to embark upon that.

Mr. Olin. I am well aware of the reaction. I talked at some length about getting rid of the postal subsidy. I tell you, the first group that reacted was the New York Symphony Orchestra. They thought that could be the worst thing that could happen to that orchestra.

So what? All the rich people in town were the ones contributing to the orchestra. We have some really weird logic in practice that just doesn't really jibe too well.

Mr. Chairman, I want to ask one more question. I apologize for taking so much time.

I want to ask Mr. Spitzer this question. I have heard from the American Hospital Association about the subject of an aggregation proposal. Could you describe to me what that is? Do you recognize it?

Mr. Spitzer. I do.

Mr. Olin. What is that? I have some material, but I haven't been able to understand it.

Mr. Spitzer. In a sentence or two, under current law, take an exempt organization that carries on a variety of activities, some related to its exempt function and some unrelated. Let's take section 501(c)(3) organization, namely, a charitable organization such as a hospital. That single organization has a variety of activities, and perhaps the taxable activities are carried on in separate divisions. There is a test stated under the regulations under current law that provides, reasonably enough, that the organization will no longer be eligible for tax exemption if its primary purpose ceases to be the carrying on of its exempt function.

For example, if an organization grew so much in its unrelated business activities that really by any test such activities become more important on an overall basis than the exempt function, you would question why should that organization continue to be exempt from tax? The so-called aggregation proposal would provide that in the case of, say, an 80-percent owned, controlled subsidiary of a tax-exempt organization that is carrying on a taxable business, you would look to the activities of that subsidiary and you would aggregate them with the activities of the exempt parent organization to try to get an entire picture of what the primary purpose of the organization, in fact, is.

There has been a lot of concern from the hospital community about this test. In part because it has not really been defined in the preliminary work by the Oversight Subcommittee as to how it would be applied.

It would be generally a facts and circumstances test, the fact that a taxable subsidiary may have a large amount of taxable income——

Mr. Olin. You would look at a combined operating statement?

Mr. Spitzer. You would look at the whole consolidated group and ask, based on a number of factors, what is the purpose of this group?

Mr. Olin. I am not much in favor of having you take that look, but maybe because——

Mr. Spitzer. I would emphasize taking that look doesn't necessarily mean in most cases the wrong answer would be reached. I think, in other words, that the existence of a lot of taxable income in a subsidiary is not, per se, fatal, if, for example, money is distributed to the parent organization, and is used for charitable purposes.

Mr. OLIN. Thank you, Mr. Chairman.

Chairman LAFALCE. Mr. Hayes.

Mr. HAYES. Thank you, Mr. Chairman. I do have a couple questions but with your permission——

Chairman LAFALCE. You have my permission.

Mr. HAYES. Wait until I finish.

Chairman LAFALCE. Whatever.

Mr. HAYES. I would like to yield to my colleague, Mr. Mfume, because he has some constituents waiting in his office. That can be political suicide.

Chairman LAFALCE. We would not want any political suicide performed in the Small Business Committee.

Mr. Mfume.

Mr. MFUME. Thank you, Mr. Chairman.

I would like to thank the gentleman from Illinois for yielding.

My thanks also to the panel. I have listened with great interest to your testimony. I thought it was well presented and should go a long way, I hope, in helping this committee in its deliberations.

I understand your advocacy for reform in this area. However, I would be less than honest if I did not indicate that while I associate myself with your stated concerns, I also harbor a very real fear about the effects of overreacting to the problem, and I would caution those who advocate reform that you move carefully and thoughtfully in your deliberations, but more importantly in your recommendations as to what we might do as a Congress to deal with some of the problems.

I think that if we paint with too broad a brush in our efforts to correct problems that have been stated thus far, we run the risk of providing a tremendous amount of disincentive for those non-profits who are serving people and who are not in competition with businesses, and I certainly would appreciate considerations to specific recommendations for specific problems that affect specific industries and that would not, in fact, be changed for change's sake.

I would like to associate my remarks with the gentleman from Virginia who offered the idea of simplification as something we may want to consider and I think it is worthy of consideration. I certainly hope it doesn't take the form of the simplification we did with the tax reform act, which is still haunting us.

But I think simplification may be another approach to being able to bring under control this unwieldy problem.

I have just two quick questions. The first I would like to address to Mr. Swain.

You, on page 24 of your testimony in the preface of your conclusion, indicated that tax advantages and other advantages for nonprofits essentially have deterred for-profit businesses from entering fields whose markets and whose technologies have expanded, and I would appreciate it, Mr. Swain, if you could give the committee some idea of what particular fields, specifically, you are talking about.

Mr. SWAIN. I think, Mr. Mfume, the growth in research and technology and information in both the for-profit and not-for-profit sector has been really significant. As my statement mentions, there is a broad and almost unlimited exemption under the current tax law for universities engaged in research. Whether that is basic research, discovering the next equation in the system of physics, or whether it is applied research, determining if a particular proposed drug meets a particular standard for a particular disease, the revenues derived from those research activities are treated pretty much exactly the same.

We are suggesting that the laws relating to research and taxation be clarified so that when the research is basic, for the general public good and knowledge, that the revenues be exempt. But where the research is specific to a product or a commercial activity, where somebody earns a profit, then that be taxed.

It doesn't sound to us like a startling principle. There are flavors of that principle in various Federal laws relating to treatment of research. But it is not an area that is real clear in the tax system.

Let me mention another situation, a court decision that was issued a few years ago in east Texas. There, a local hospital was dispensing pharmaceuticals, not an unusual situation in and of itself—but it was dispensing pharmaceuticals to the townspeople, in addition to the hospital patients. Its exemption was challenged by the Internal Revenue Service and the court ruled that it ought to retain the exemption because it was servicing an area in which there were no drugstores, in effect.

This is interesting to me because if that hospital continues to dispense drugs in that area, what incentive does an entrepreneur have to come in and set up a drug store in competition with the hospital?

That, in sort of microcosm, is the issue. If there are not-for-profit competitors in an area first which enjoy significant advantages—and I am not only talking about Federal income tax, but exemption from Federal property taxes and so on—that seems to me to be a disincentive for the for-profit community to go in and compete against them. We hope some changes can rationalize and straighten out those types of cases.

Mr. MFUME. I have in my district Johns Hopkins University and Johns Hopkins Hospital and two or three other teaching hospitals and research organizations which I am sure have very strong opinions about this. In the research that you or your colleagues have done as it relates to business and their concerns, have you also tried to get input from institutions such as that would be severely affected, I think, by limitations under the proposals that we have had before us today?

Mr. SWAIN. Mr. Chairman, I have not personally discussed the issue with people at Johns Hopkins although I believe somebody in my office actually has, and I have not been reluctant to talk to, and have sought out, a lot of discussion and conversation with a variety of associations and individual organizations in the not-for-profit sector. The sorts of issues I am sure would be raised by the Johns Hopkins people do deserve really a close look in and of themselves.

Harkening back to your opening remarks, the Congress really has two choices here, but they are not exclusive choices. One choice is a broad rewrite of the not-for-profit tax laws, some of which we have advocated. Another choice is individual changes in individual aspects of the laws. That is obviously the direction the Ways and Means Oversight Subcommittee is going now.

My perspective is the Congress ought to go ahead and pursue individual changes in individual areas of laws where a case has been made that change is currently merited, but having done that, Congress ought not to forget about the fact that broader changes may be appropriate when we get a little more evidence and record in as to what effects those changes will have.

Mr. MFUME. Just one other question, Mr. Chairman, if I might.

Ms. Stathis, you indicated also that fees are charged for services related to the tax-exempt activity of a number of organizations. I would like to hear from you if I could a little specificity as to who and what fees and for what services you were referring to.

Ms. STATHIS. I don't know that I have any more specifics to add on that particular issue; but we talked to a number of organizations that are listed in the appendix to our report of last year, and these are general generic answers from those people.

Mr. MFUME. So we don't know just which non-profits may be charging fees for services related to their tax-exempt status?

Mr. SPITZER. The two that come to mind are educational institutions and hospitals where they are charging tuition, charging for health care. Those are both, in a sense, commercial activities, yet the income is tax exempt. I think those are the two largest examples.

Mr. MFUME. Let me say in concluding my own remarks, I don't know if the scope of the problem is as large as it seems. I understand, I think, the position of businesses. I would argue that it had probably been the position of businesses for as long as they have had to compete with non-profits. Although they argue, of course, that it is just recently the scope of non-profits that has grown to bring about their concerns.

But, on the other hand, I think we have to be very careful we don't open up a Pandora's Box by being just broad in our approach to this. I know there are a number of non-profits that help people, they provide services for people who have a genuine concern who are not, let's say, competing with businesses because of the services they provide.

And I think they have to be protected and their ability to operate has to be protected and we don't need to, in rushing to do something, create a disincentive for them. This is an interesting subject. It is probably one of the more interesting ones, Mr. Chairman, since I have been on this committee and I am looking forward to continuing hearings on it.

I got up earlier to ask the chairman whether or not there is legislation pending on this and he said no, but there could be some soon. It is an interesting issue and I think the full Congress ought to have the opportunity to look at it as well.

Thank you very much.

Mr. SPITZER. Mr. Chairman, if I could address a point made by Mr. Mfume.

This is an area in which haste is unwarranted. I would like to strongly endorse your comments. It is not an area we want to overreact in or an area in which quick action is always necessarily appropriate.

To the extent that there are problems, I don't know as it would be impossible to reach a consensus between exempt organizations and taxable businesses as to discrete areas of change.

I don't view it as a battle between tax-exempt organizations and I would have to emphasize strongly all of us in the Administration feel strongly about the importance of the good deeds and innumerable contributions made to our society by exempt organizations.

If you overreact in this area, you can't come back five years later and say will you come back and start doing those good things again. It is a sensitive area. We appreciate that.

Chairman **LaFalce**. I don't think we will have any bill to abolish not-for-profits marked up today.

Mr. Hayes.

Mr. **Hayes**. Thank you, Mr. Chairman.

To continue on in the vein in which my colleague had begun, I want to get into one specific area that bothers me an awful lot because of my own constituency concern. The Postal Service, which you alluded to, I guess, is one of the largest entities in the Federal Service that is subsidized by the Government. I want to leave here with a clear-cut understanding, particularly with you, Mr. Swain, as the Chief Counsel for Advocacy, Small Business Administration, are you for the privatization of the Postal Service or not? I must know.

Mr. **Swain**. Mr. Hayes, if you will grant me, to use Mr. McDade's language, the opportunity to revise and extend my remarks since my statement this morning didn't really address that, I would say in principle I am taking a good, hard look at aspects of the Postal Service, and there may be some parts of it that may be privatized. But I don't believe our office has come out with a proposition the whole thing ought to be privatized right now.

I think it is an important question and one that we ought to continue to take a look at. I would be happy to provide the committee with some further information or statements on that position after I have had an opportunity to think about it a little more.

Mr. **Hayes**. I would be happy to know your answer a little later on. You reflect, obviously, the thinking of the administration. I imagine you have influenced that thinking on a lot of matters.

Mr. **Swain**. I am sorry, I should also mention my responsibility is not only to reflect the thinking of the administration; in fact my primary responsibility, as my colleagues in the administration can tell you, my primary responsibility is to reflect the thinking of small business, and we have heard some complaints in all of these areas I have talked about from small business.

We, of course, attempt to rationalize that with the administration's position. There are also some people from Illinois who have contacted me on a regular basis who are churned up about competition they are getting from the Postal Service. There are a lot of sides to that issue.

Mr. **Hayes**. Mr. Spitzer, in the same vein, do you have any figures or statistics that show tax savings that might be the result of—tax losses, I should say—that might result from the replacement of a postal worker by a robot sorting mails?

Mr. SPITZER. I don't have knowledge of those figures.

Mr. HAYES. Would you take a look into those areas?

Mr. SPITZER. I would be happy to.

Although we have not specifically analyzed the potential tax loss that would be associated with laying off a postal worker, the answer to your question would depend largely on whether the employee would be able to find comparable employment elsewhere. In light of the relatively low level of unemployment in our country at this time, such substitute employment would appear likely and hence there would be little, if any, tax loss.

Mr. HAYES. All postal workers pay taxes. Thank you, Mr. Chairman.

Mr. McDADE. The chairman had to take a call. We thank you all for your testimony. With the thanks of the committee, we would put you in abeyance maybe to come back again. We will now have the second panel. Thank you very much.

Chairman LAFALCE. Would the second panel please come to the table? Our first witness will be Mr. Richard Steinberg, Associate Professor of Economics, Virginia Polytechnic Institute and State University. Gentlemen, because of the time constraints, it will be imperative that each of you limit your presentation to no more than 10 minutes.

TESTIMONY OF RICHARD STEINBERG, ASSOCIATE PROFESSOR OF ECONOMICS, VIRGINIA POLYTECHNIC INSTITUTE AND STATE UNIVERSITY

Mr. STEINBERG. I am quite pleased this committee has invited me to speak. When we decide how to regulate the competition between sectors, we are deciding the type of society we live in. I commend this committee for trying to understand and referee the battle between two of its charges, for it is little realized most non-profits are small businesses, too.

I have focused my research exclusively on the non-profit sector ever since the latter part of graduate school eight years ago. I have learned a lot in those eight years and have come to appreciate the exciting research challenges which reflect our vast ignorance at the current time. Although policy cannot await academic certainty, we ought to move slowly.

As this committee is not yet ready to propose specific legislation, I will present some broad principles for regulating competition. In summarizing my written remarks, I would like to focus upon three questions: First, how can we tell when competition is unfair? Second, how do non-profit tax and regulatory advantages affect their behavior? Third, what are the impacts of the unrelated business income tax upon economic efficiency?

Most of the previous discussion of fairness is centered around the playing field analogy where competition is regarded as unfair because tax and regulatory breaks tilt the field to the advantage of non-profit players. I do not think this analogy provides useful guidance. I am not even sure non-profit and for-profit players are in the same game.

Further, if you try to judge each particular tax and regulatory facet in isolation, you will get lost in the topography of a bumpy and pitted playing field. Thus, I propose an alternative way of thinking about fairness, which I refer to as a "symmetry standard." Competition is unfair by this standard if the typical owner of a for-profit firm would like to switch places with the owner of a non-profit and cannot.

When for-profits can convert to non-profit status, allegations of unfairness ring hollow. In fact, in the hospital sector, the trend has been in the other direction, with many non-profit hospitals becoming for-profits. Non-profit hospitals may have isolated advantages, but if these advantages allow an unfair competitive edge, why are so many hospitals voluntarily handicapping themselves?

More commonly, conversion is difficult. Then the standard requires an answer to the hypothetical question: "Would they switch places if they could?" It is doubtful current owners would wish to trade places with their non-profit brethren because the owners of non-profit firms cannot convert their annual surplus to their personal use. Any profits must be plowed back into the firm. Owners of for-profit firms don't get to keep all their profits because they must pay the Federal corporate income tax, but owners of non-profit firms don't get to keep any of their profits. Thus, I do not believe the typical for-profit manager would prefer to operate as a non-profit despite purported loopholes in the unrelated business income tax and exemption of related income from the corporate tax.

I find no unfairness in the current system. This does not mean that I support the entire panoply of tax and regulatory advantages provided for non-profits for there are other issues as well. We do not yet know the exact determinants of non-profit behavior; as everyone else has commented, we have a few useful hints that might guide the committee in later work.

In a world where non-profit firms were given no special breaks, they would not be able to survive for long if their behavior departed from that of their competitors. Even a non-profit organization must break even. Tax and regulatory breaks and other restrictions on competition from for-profits provide a financial cushion that allows them to behave differently. This cushion allows both socially useful and detrimental behavior on the part of non-profits which I will refer to as good and bad deviations.

There are two principal good deviations, production of commodities with external benefits and enhanced trustworthiness. Earlier speakers discussed the first rationale, and it was asked whether there were other rationales for non-profit exemption. That speaker did not refer to the "trustworthiness" idea, which I will discuss further.

Going back to the first, a commodity has external benefits if it doesn't just help the person who is buying it, but benefits society as well. Many of the outputs sold by non-profit organizations or financed through donations provide external benefits, including traditional charity, health care, day care, nursing care, research (which was specifically mentioned as an area for committee attention), education, arts, and culture. Conversely, for-profit firms have strong incentives to under-provide these goods, offering them sporadically and only for their publicity value. The mere fact that a for-profit firm is offering the goods somewhere does not mean that the non-profit shouldn't be involved, because the non-profit may provide a different quality or the for-profit may have its profit reasons to keep the goods scarce.

When the seller is better informed about the qualities of the product than the potential buyer—and traditional remedies, such as guarantees, do not work well—for-profit firms have a strong incentive to exploit their informational advantage and cheat the customer. If they did not, they might get driven out of business by more scrupulous for-profits or taken over by greedier entrepreneurs. In contrast, when non-profits are given a regulatory cushion, they can deviate and behave honestly with no threat of a take-over bid.

There are three principal bad deviations: Sheer waste, increased market share, and high salaries. More efficient for-profits can be driven out of business by less efficient non-profits solely because of Government subsidies. Ideally, we would like tax and regulatory policy to provide bigger cushions to those non-profits that practice good deviations and no cushions to those practicing bad deviations. We don't yet know enough to implement such a policy.

My advice is to first think about the incentives provided by particular tax or regulatory policies and see which ones are likelier to encourage good behavior. For example, exemption from a sales tax increases market share to a much greater extent than exemption from an income tax.

Second, consider wider use of a public support test when granting particular benefits. Organizations which receive substantial donations are probably those which are providing goods with external benefits.

Third, consider linking benefits to enforcement of noninurement. Noninurement is a little stronger than nondistribution of dividends to owners. It means the manager cannot have a profit-sharing plan (perhaps) and other ways of getting the benefits out to the members of the organization are prohibited. Noninurement is enforced for the corporate income tax exemption, but it is not always required for some of the other benefits non-profits receive.

I would like to turn specifically to the UBIT. Sometimes it is efficient for society as a whole for a non-profit to provide seemingly unrelated services, and this is due to economies of scope. These may be due to efficient utilization of spare capacity as when the University sports stadium is rented out for a rock concert, to supportive interrelationships with fund-raising, as when the Metropolitan Museum of Art markets reproductions, or to other factors.

Sometimes it is a bad idea for a non-profit to provide unrelated services. This occurs when the direct production and marketing costs are lower in the for-profit sector, and the only reason non-profits can compete is that they are provided with a tax advantage.

In general, efficiency is obtained when tax treatment is neutral. That is, non-profits receive the exact same treatment for unrelated income that for-profits receive for their income. Many non-tax proposals, such as proposals that would restrict non-profits from selling certain items, are inefficient because they restrict non-profits from obtaining desirable economies of scope. They are also unnecessary, as a neutral tax would eliminate those activities whenever it was inefficient to provide them.

But obtaining true neutrality is difficult. Many of the current exemptions from UBIT would have to be eliminated to make the tax system neutral, including the exemption of products provided for the convenience of members.

On the other hand, non-profits would have to receive new exemptions. One is given by the tax deduction a for-profit can claim for charitable deductions. If they can take 10 percent of their corporate income tax, the non-profit ought to get a 10-percent deduction from its UBIT. For-profit firms that operate in several industries can offset losses in one line against gains in another. Neutrality, therefore, appears to require that non-profits be able to offset losses in their exempt purpose against gains in their unrelated activity; although this is more complicated, I don't really want to recommend it quite yet.

Current research is revealing a lot about the functions of the non-profit sector in our mixed and pluralistic economy. I am happy you are talking about the need for more research, that being what I do. I hope we will soon be able to replace the patchwork of piecemeal policymaking with an integrated whole.

These hearings can only help encourage the research necessary to cross that threshold. I thank you.

[Mr. Steinberg's statement may be found in the appendix.]

Chairman LAFALCE. Thank you, Mr. Steinberg.

Our next witness is Mr. Lester Salamon, director of the Institute for Policy Studies at Johns Hopkins. Mr. Salamon, we ask every witness to try to summarize their remarks within about a 10-minute period.

TESTIMONY OF LESTER M. SALAMON, DIRECTOR, INSTITUTE FOR POLICY STUDIES, JOHNS HOPKINS UNIVERSITY

Mr. SALAMON. I am Lester Salamon, director of the Institute for Policy Studies at Johns Hopkins University in Baltimore, MD.

I, too, am pleased to be here. I want to commend this committee for its attention to this issue and for the very fair and balanced way I think it has organized these hearings.

The request to testify today reached me as I was about to take off for a vacation. Therefore, I was not able to submit a formal prepared statement. However, I have submitted a paper that I wrote on this topic a year ago which I respectfully request be submitted for the record.

My testimony today draws on a major research project I began at the Urban Institute several years ago and am continuing at the Johns Hopkins University, a research project focusing squarely on the finances and structure of the Nation's non-profit sector.

Among other things, this research featured a major survey administered to over 6,800 private, non-profit organizations in 16 jurisdictions, 12 of them metropolitan and four of them rural, throughout the United States.

The survey was administered in two waves, one in 1982 and one in 1985, creating what is a unique longitudinal data base on the scope and structure of a major portion of the non-profit sector in this country.

This is in a sense the only major source of data on non-profits other than the Internal Revenue Service data. It has, I believe, certain advantages over the Internal Revenue Service for focusing on the issue that is the subject of these hearings.

I should point out that my testimony today represents my views only and not necessarily the views of the Urban Institute or the Johns Hopkins University or any of the largely private funders of this research project.

The major point I want to emphasize today is that much of the flurry of attention that has come to focus on non-profit competition with private business turns out to be based on very serious misperceptions of the real scope and character of non-profit commercial activity.

It is my belief that we heard this morning some examples of this very serious misperception. In addition, based on my review of the data, it is my belief that current law properly enforced provides the best way to protect the legitimate concerns of small businesses about unfair competition with non-profits.

Given the current lack of information in this field, any change in existing law is likely to produce as many problems as it solves. This seems especially true, in my view, of efforts to spell out in law activities that are "inherently commercial," as opposed to those that are "inherently non-commercial."

What leads me to these general conclusions are three major findings of the research that I conducted over the past five or six years, research that is summarized in the paper I submitted to you. Let me summarize these findings very briefly.

Point number one: Popular discussions of the commercial activities of non-profit organizations in my opinion tend to lump together in very confusing fashion two very distinct and different types of activity.

The first type of activity is the sale of products or services that are at best ancillary to the objectives and central mission of the non-profit organization, for example, the sale of access to data processing equipment or the sale of travel services.

I refer to this in my writings as "ancillary business activity." It is activity that is carried out by the non-profit ancillary to its central mission involving sales of products or services.

I believe that kind of activity is very different from a second type of activity that takes the form of charging agency clients a fee for the services that are an essential part of the agency's mission, often on a sliding fee scale.

This is what is traditionally referred to as "fee-for-service income."

In my view, much of the attention that has come to focus on nonprofit commercial activity has had in mind the first of these two kinds of activity. That is the kind that I think most people have in mind when they complain about the commercial involvement of non-profits. The image is of non-profits selling a product that is ancillary to their basic mission and in that regard violating or going beyond the mission of the agency.

By contrast, the fee-for-service income I believe tends to be overlooked. It certainly is overlooked in press accounts. I think it tends to be overlooked in much of the testimony and discussion of the topic.

It is, therefore, extremely important to be clear about the scope of these two very different kinds of non-profit activity and it turns out the scope of the two varies considerably. This brings me to my second point which has to do with the scale and scope of what I refer to as "ancillary business activity." Based upon our research, what we discovered is that despite the flurry of interest and the extensive press scrutiny, the scale of ancillary business activity on the part of non-profits is quite small, at least among the agencies that we surveyed, which tended to be public-benefit service organizations with the exclusion, and an important exclusion, of hospitals and higher education.

Based on our data, this kind of activity, ancillary business activity, represented less than 6 percent of non-profit income in 1981. To put that into some context, in that same year, the non-profit organizations received 20 percent of their income from charity, that is, from individual donors or corporate contributions or foundations, and about 40 percent from Government. So Government was 40 percent of the income, 20 percent was from charity, and only 6 percent from the sale of products or services of an ancillary variety.

What is more, there was little evidence of change in this kind of activity during the period that we studied. We looked particularly at the early part of the 1980's, during the time of most intense cutbacks in Government support and found little evidence of significant increase in non-profit receipts from ancillary business activity.

What is more, we found that the share of the agencies that report any income from this source is rather small, less than 30 percent of all the non-profits we surveyed as of 1983 reported receiving any income from this source.

The most dominant area where this kind of activity was going on in the sector was in the case of arts agencies and employment and training agencies.

They were the only ones to receive as much as 15 percent of their income from this kind of ancillary business activity.

So the second point is that the ancillary business activity, the sale of products that are divorced from the central mission of the agencies, turns out to be, in fact, considerably smaller than some of the press accounts and complaints would lead one to believe.

The third point, however, is that while ancillary business activity is far more limited than many believe, fee-for-service income, the other type of commercial income of the non-profit sector, is much more widespread and much more rapidly growing than many people believed when we began our research.

This form of income, fee-for-service income, accounted for close to 30 percent of the income of non-profit organizations in 1981. More than all sources of private charity combined and the second-most important source of income to the sector. The most important source of income is Government.

The second most important source is fee-for-service income, and the third most important is private charity.

Chairman LaFalce. I will ask you to sum up in a minute or so.

Mr. **Salamon**. The point is that fee-for-service income turns out to be quite substantial as the second-most important income source for the sector.

Almost 80 percent of non-profits engage in this kind of activity. What is more, this kind of activity has experienced a considerable increase in the early 1980's. It increased 21 percent between 1981 and 1983.

It accounted for three-fifths of the new income the non-profit sector received. In other words, fee-for-service income was far more important than private giving in allowing the sector to cope with budget cutbacks.

So, in conclusion, while most of the attention in recent years has tended to focus on the new-found entrepreneurial and for-profit business ventures of non-profits, such ventures are dwarfed in fact as a source of income by the fee-for-service activity in which non-profits engage.

Such fee-for-service activity is a major part of the financing of the American non-profit sector. What is more——

Chairman **LaFalce**. This fee-for-service, they are exempt also, are they not?

Mr. **Salamon**. Yes. But it is related to the basic charitable mission of the agency. It is the charging of fees frequently on a sliding scale for day care and tuition at universities and so forth.

It is a major source of income but is a central part of the basic financing of the sector and a long-standing historic source of support. Unfortunately, it is not a source of support that we know a great deal about. We don't know how organizations set their fee structures. We know very little about how common it is to have sliding fee scales. We know very little about the cross subsidization that occurs.

That makes me very wary of radically altering this source of income. It can make very, very significant changes in the structure of these agencies.

[Mr. Salamon and Ms. de Vita's statement may be found in the appendix.]

Mr. **McDade**. I know you are going on vacation——

Mr. **Salamon**. I am back from vacation.

Mr. **McDade**. Do me a favor.

I appreciate your testimony. It is really good. It gives us a lot of points to look at.

On page 4 of Mr. Swain's statement, he quotes the Bureau of Economic Analysis and shows, for example, a very large rise, 6 percent of the GNP in the overall look at things. Then he has statistics that—I don't know if they are in conflict with yours, going from master file at the IRS which we hear is not really completed yet.

He says two-thirds of all the revenue from non-profits in 1983 came from related and unrelated business receipts. He is basing that on a master IRS file of 1983. Your data is 1981–83. Would you look at it?

Mr. **Salamon**. Yes. I am familiar with the data sources used here. I think there are very serious problems in definitions in the IRS data.

Mr. **McDade**. Would you focus that for us?

We have to rely on people who have an opportunity to look at these issues. I would be grateful if you would look at that and write us a note when you get a chance.

Thank you.

Thank you, Mr. Chairman.

[Mr. Swain, Chief Counsel for Advocacy, SBA, submitted correspondence clarifying the above, which may be found in the appendix.]

Chairman **LaFalce**. Was there any conclusion you wanted to draw?

Mr. **Salamon**. My basic conclusion is I think the current law is satisfactory to deal with the problems that exist. We ought to be very wary of changing it but we need stronger enforcement of it. Beyond this, legislative initiatives that focus on the ancillary business activity rather than the fee-for-service income for the ability of non-profits to carry out their charitable missions, seem destined to be irrelevant at best, and counterproductive at worst.

Chairman **LaFalce**. All right.

Our next witness will be Mr. Dennis Young, director of the Mandel Center for Non-Profit Organizations at Case Western.

TESTIMONY OF DENNIS R. YOUNG, DIRECTOR, MANDEL CENTER FOR NON-PROFIT ORGANIZATIONS, CASE WESTERN RESERVE UNIVERSITY

Mr. **Young**. I am very pleased to be here. In the interest of time, I would like to summarize some of the key points I made in my written statement. I assume that it was received. My institution spent some of its non-profit postal benefits to get it to you quickly!

Overall, I believe that the question of policy on competition between non-profits and businesses needs to be seen in the context of not only fairness to business but also impact on the non-profit sector. As Professor Steinberg has covered very nicely, non-profits perform vital functions in our economy and their services have a special character.

Increasingly, non-profits have been relied upon to provide public services where Government has not stepped in or has cut back. Yet non-profit organizations are caught in a fiscal squeeze, largely as a result of governmental policies. Those policies include reduced Federal expenditures in areas where non-profits operate, and Professor Salamon's research at the Urban Institute speaks most eloquently to that question; tax reform provisions which include lower marginal tax rates and elimination of above-the-line deductions, all of which have made charitable giving more costly; and a subject which came up frequently this morning, incursions by the business community into areas traditionally served by non-profit organizations.

Commercial activity is one area of potential relief that non-profit organizations have sought to develop. However, such activity is not a new strategy. It has been a part of non-profit financing for a long time; nor is it a dominant or overwhelming phenomenon, as my colleague Lester Salamon has indicated.

Earned income, that is, revenue from service fees, is not the primary source of non-profit revenue, in general, and most earned income is from fees directly mission-related to non-profit organizations' services. Most other venture income is a natural outgrowth of non-profit organizations' conventional activities and capacities, such as the sale of art reproductions in museum gift shops or the use of idle classroom capacity. I believe most of this venture activity is specialized and not competing head-to-head with preexisting business products and services.

Still, there is a competition issue, but the issue of fairness between business and non-profits is a very complex one. Several points need to be made here. First, use that non-profit organizations make of financial surpluses or profits is as legitimate, I believe, as that made by businesses. Those profits are plowed back into the mission-related services of these organizations.

Second, a level playing field, if that is the objective, requires scrutiny of the alleged advantages on both sides of the fence.

And, third, I believe addressing the needs of the non-profit sector——

Chairman LaFalce. What are the advantages on the other side of the fence?

Mr. Young. Excuse me? In terms of——

Chairman LaFalce. You were talking about being fair. Therefore, you said the advantages on both sides of the fence should be scrutinized. I wondered what the advantages were on the side of the for-profit businesses.

Mr. Young. Governmental programs that are set-aside contracts for businesses for which non-profits would not be eligible or tax rollover provisions that might pertain to a business and not to a non-profit. Also, businesses have access to sources of capital, namely, sale of equity or stock, which non-profits do not have.

I am not an expert on this particular subject. There are research papers which I referred to in my paper which try to get at some of those issues. I think it is an area that requires additional investigation.

If we believe that non-profit organizations provide valuable services, then we need to look at the support for these organizations, and that will require some form of public support. It is not clear to me that allowing commercial ventures by non-profits, which might be looked at as a way of indirectly taxing business by causing their returns to be below market, if indeed that is the case, is better or worse than other means of support for the non-profit sector.

That is, we need to look at what the alternatives are, and to determine what the impacts are of those various ways of supporting the sector, whether it be tax exemption or direct governmental provision or allowing commercial activity.

I do think that in formulating policy for this particular area, it is important to ensure that non-profit organizations do not stray from their appropriate missions. However, I do not believe this implies severely restricting commercial activity but rather assuring that such activity does contribute to, and is undertaken for the purpose of, pursuing the non-profit mission.

In general, I believe non-profit organizations are guided by their missions in undertaking commercial ventures. Integrity in the sector is high. Mission oriented motivations are strong. Certainly continuing scrutiny of purpose and behavior by non-profits by the IRS and other agencies is appropriate.

I also believe that managers of non-profit organizations need increasingly to emphasize mission-focused planning in order not to lose their way in this changing world.

In summary, however, and I agree with my colleague, Professor Salamon on this, I see no immediate justification for major changes in existing treatment of commercial activity by non-profits. Certainly, any such change should take into account the impact on the economic viability and the effectiveness of the non-profit sector.

Overall, the debate needs to be widened and re-focused to include how best to assure the viability of the non-profit sector. Certainly there are legitimate research questions that need some answers.

Some of these are: How much commercial income by non-profits actually does represent new activity that competes directly with existing business? I don't think we know the answer to that.

What is the incidence of economic burdens if, in some cases, non-profits cause businesses to endure below-market returns?

How do these burdens compare with other alternatives to finance non-profit organizations, such as increases in direct governmental funding or increases in deductibility of charitable contributions?

And most importantly, what would be the economic and social impacts of changes in existing tax treatment of commercial income by non-profit?

The committee could perform a valuable service by stimulating rigorous inquiry into such questions.

Thank you very much.

[Mr. Young's statement may be found in the appendix.]

Chairman LaFalce. Thank you very much, Mr. Young.

Our next witness will be Mr. Peter Hall, lecturer on Non-Profit Management at Yale University.

TESTIMONY OF PETER DOBKIN HALL, LECTURER ON NON-PROFIT MANAGEMENT, INSTITUTION FOR SOCIAL AND POLICY STUDIES, YALE UNIVERSITY

Mr. Hall. Thank you very much.

It is a privilege to be here. I wear a number of hats. I teach non-profit management and I am involved in managing organizations.

But I am trained as a historian. Today I will address you as a historian because I think that when one begins to move the pieces, the framework, of the marketplace around, it is important to take a long view.

First of all, it is important that we understand that for-profit and non-profit business have a very long history in this country.

Chairman LaFalce. Could you pull your microphone a bit closer?

Mr. Hall. Yes. When we look at that history, we find that Government, business, and non-profits offering the same services in the same markets to the same body of consumers and citizens is not at all unusual. Government and charitable enterprises traditionally have enjoyed much the same kind of advantages—tax exemption and some form of deductibility—as they do today. Proprietary businesses sometimes as well. The divisions between for-profit and non-profit, public and private, were not as clear as they are today. They may not even be as clear today as we would like to think, as Mr. Salamon has helped us understand.

The effects of this unfettered and unregulated competition among businesses, charities, and Government, are well known. The marketplace, commercial and cultural, social, flourished. American industry like the American arts became noted for their extraordinary diversity, variety, innovativeness, and capacity for growth. Taking the long view, competition between the sectors isn't such a bad thing.

Why were the Americans of the 19th Century who were well-known to be acutely sensitive to encroachments on their liberties willing to permit privileged tax-exempt organizations to compete freely with non-privileged proprietary enterprises in culture and in commerce? The answer is two-fold. First, they seemed to have perceived that the relationship between for-profits and non-profits, to use the modern terms, was synergistic: That they worked together, that they were mutually beneficial in creating markets for their common products, be those products musical, educational, commercial, or industrial. They accepted the idea that each benefited from the actions of others.

Second, citizens understood the greatest threat to liberty was Government intervention, not competition between organizations. Given the choice of evils, they seemed to have chosen the market as mediator. To be sure, they acknowledged the tax exemption and the ability to accumulate endowments conferred privileges on charitable enterprises. But they also understood these advantages were offset by the limitations of charitable status. Charities were, in theory at least, accountable to the State. Their funds and activities were subject to a far greater degree of stake-holder, member, trustee, constituency control than those of sole proprietorships, family firms, or even publicly held corporations. They could not attract investors through sales of stock. They could only appeal for donations, bequests, or patronage. The funds and activities of charitable organizations were limited to their charter purposes. They could not, as businesses could, shift their activities to more remunerative fields without cumbersome legislative and judicial proceedings. In my opinion, the situation in the 19th Century is not that different from the situation today.

It is true that in our own century, non-profit enterprise has come to dominate certain kinds of activities. For example, by 1900, most higher education, art museums, symphony orchestras were either public or non-profit entities despite the fact that through most of the 19th Century performing arts were dominated by commercial enterprises.

This shift, I would argue, was less a function of the advantages conferred by tax exemption than a matter of changes in the market itself, particularly market segmentation. As the range of educational and cultural products became increasingly specialized, taxed and untaxed institutional actors by their own free choices chose to concentrate in certain areas of endeavor. In some areas such as vocational education and popular music and theater, proprietary firms remained and in many cases still remain dominant. In professional education and classical music and theater, non-profit firms became dominant. However, at no point were for-profit actors barred from higher education or providing high culture. Indeed, in the field of music, a commercial broadcaster like the National Broadcasting Company remained a major producer of classical music, maintaining an orchestra conducted by Maestro Arturo Toscannini. When NBC went out of the classical music business, it did so because its assessment of changing public tastes led it to decide its air time could be used more profitably. The division of market between for-profit and non-profit entities was a matter of free choice on the part of consumers and investors, not a product of intrinsic advantage enjoyed by one kind of organization or the other.

I want to skip through much of my statement to the end, however, to address the question of policy since we have so little time. Specifically, I want to suggest the kinds of policy solutions that the committee might consider.

Given the long history of competition between the three types of enterprise and the abundant evidence that all three continue not only to flourish but also to significantly complement one another, I suspect the best policy is the least policy, a hands-off policy.

Once again, in this regard the historical record is a valuable teacher. In the early years of this century, small businessmen attempted to persuade the courts and the Congress to prevent the sale of nationally advertised brand name products, claiming that such products presented unfair competition to retailers. The eminent Justice Brandeis, a supporter of this movement, argued that:

> The nationally advertised branded goods make the retailer practically an automatic machine, instead of an expert to whom the consumer pays, in profits, compensation for expert services and trustworthiness....In a large part of the field there is no social justification for the national widespread market for the trademarked articles.

Brandeis feared that the chain stores and mass-produced nationally marketed products would eliminate the small businessman—the family grocery, the corner druggist, the hometown hardware store—and that, as in many heavy industrial sectors, trusts and monopolies would displace independent producers.

Brandeis' heart was in the right place. His sympathy with the plight of small businessmen at the mercy of vast impersonal enterprises was commendable. It is too bad that his concerns did not extend to consumers who had to pay the artificially high prices that resulted from so-called "fair trade" legislation. Consumers might be, as Brandeis supposed, "servile, self-indulgent, indolent, and ignorant." But their needs also varied: Some were happy with what the chain stores offered; others preferred to buy other kinds of products in other kinds of settings.

I think this is very important. While it may look like non-profits and for-profits and Government agencies are offering the same goods, there are differences. There are differences of setting, differences of quality, differences in the human relationships of production and consumption which are quite difficult to measure. In view of these preferences, is it the place of Government acting on behalf of some special interest group to decide for consumers where they can buy?

In fact, the historical record has proven Brandeis and the advocates of "fair trade" legislation wrong. Not only have national chains and brand name products proven to be of immeasurable benefit to consumers, creating efficiencies of production and distribution enabling all to share in America's bounty, but small retailers have remained a flourishing and important part of the distribution network. In fact, it can be argued that the rise of national businesses, while perhaps foreclosing opportunities for small businessmen in certain areas, opened them in others by creating vast new markets for specialty goods and services. The lesson of efforts to promote "fair trade" in business is plain: When governments attempt to regulate competition, they strike at consumer preference, which is the core of a market economy.

To conclude, current efforts to restrict commercial activity by non-profits are, I think, another manifestation of the largely discredited effort by Government to create fair trade, to regulate competition. As such, I think it shows a contempt for consumers and their interests and an indifference to the historical record as well as an astonishing though perhaps not surprising solicitude for groups which tend to place their own desire for special privileges over the greater good of a free market economy.

Thank you.

[Mr. Hall's statement may be found in the appendix.]

Chairman LAFALCE. Thank you very much, Mr. Hall.

I have no questions.

Mr. Hayes, do you have any questions?

Mr. HAYES. Thank you, Mr. Chairman. I have no questions. Excellent testimony.

Chairman LAFALCE. I want to thank you all very, very much. This is a complex subject. Surely our committee is not going to be rushing off to do anything in any hurry.

I don't know if we will do anything this year at all. We do want to study the problem and lay the groundwork for careful deliberations in the future for whatever information gathering, better enforcement of laws, modifications of laws might be in order.

Tomorrow we are also going to have an excellent set of witnesses. We initially were going to have two separate panels but I am going to change that. We will have one panel. It will begin with testimony from Mr. Joseph O'Neil, president of the Business Coalition for Fair Competition. Then we will hear from a witness who would have been on the second panel. We will then go back and forth and back and forth. This way we will be able to have a dialogue among the witnesses with differing perspectives on the issues rather than getting essentially a unanimous perspective from one panel and a unanimous but different perspective from another panel.

We will have one panel with a tremendous diversity of issues and perspectives at the same time.

Until tomorrow, the Small Business Committee is adjourned.

[Whereupon, at 12:10 p.m., the subcommittee was adjourned, to reconvene at 9:30 a.m., Wednesday, June 29, 1988.]

NON-PROFIT COMPETITION

WEDNESDAY, JUNE 29, 1988

House of Representatives,
Committee on Small Business,
Washington, DC.

The committee met, pursuant to notice, at 9:40 a.m., room 2359-A, Rayburn House Office Building, Washington, DC, Hon. John J. LaFalce (chairman of the committee) presiding.

Present: Chairman LaFalce; Representatives Olin, Bilbray, Mfume, McDade, Dreier, and Hefley.

Chairman **LaFalce**. The Small Business Committee will come to order.

Today, our committee will hold the second day of hearings on the issue of competition by non-profit organizations with small business.

Serious concerns have been raised by the small business community about the increasing commercial activities of the non-profit sector and their competitive impact on for-profit activities.

Business representatives argue that Federal and State tax exemptions and other benefits enjoyed by non-profits give them unfair competitive advantages in areas where for-profit businesses are providing the same goods and services.

The non-profit sector, on the other hand, maintains that its income-producing activities are a legitimate expression of their exempt purpose activities. They argue that the competition problem is more the result of taxable business entering traditional tax-exempt areas rather than an increase in non-profit commercial activities.

The principal objectives of these hearings are to identify how tax exemptions and other benefits provide non-profit organizations a competitive advantage in the marketplace, and to identify the specific industries and type of activities in which that competition has the greatest impact on small business.

The committee received testimony yesterday from Government witnesses and academicians, who provided a broad overview of the non-profit competition problem and the underlying policy rationales for the taxation of unrelated business income.

Today, we will hear testimony from representatives of the business community and representatives of the non-profit sector.

Yesterday, we had two separate panels. We are not going to do that today. In order to ensure a wide-ranging debate and a full and free exchange of views on this important issue, I would like to ask all eight witnesses that were originally scheduled for two separate panels to form a single panel.

We will then alternate testimony between non-profit and for-profit witnesses, and I think that the questions that ensue and the discussion that ensues will result in a much better joining of the issues.

But first, our lead-off witness this morning will not be from the outside world, but from the inside world of Congress: The Honorable Pat Williams, Representative from the State of Montana, and Chairman of the Subcommittee on PostSecondary Education of the Committee on Education and Labor.

He will give us his perspectives on the non-profit competition issue as it pertains to the activities of educational institutions.

At this point, before we hear from Congressman Williams, I would like to introduce the opening statement of Congressman Silvio Conte into the record.

[Mr. Conte's statement may be found in the appendix.]

Chairman LaFalce. We will also include the entirety of Congressman Williams' statement in the record, and he may feel free to read it or summarize it as he wishes.

[Mr. Williams' statement may be found in the appendix.]

TESTIMONY OF HON. PAT WILLIAMS, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MONTANA, AND CHAIRMAN, SUBCOMMITTEE ON POSTSECONDARY EDUCATION, COMMITTEE ON EDUCATION AND LABOR

Mr. Williams. Thank you very much, Mr. Chairman, members of the panel. I appreciate being with you.

This issue of competition between non-profit and the small business community is, I believe, an important national issue, and I commend you for this series of hearings.

I spent a large part of my life in small business. I had restaurants in Montana, and, so, I understand the value and genius of the profit motive in the United States and continue to be supportive of it.

Since coming to Congress, I have been a member of the Committee on Education and Labor, and I now serve as the chairman of its Subcommittee on PostSecondary Education.

I am aware, as are the members of this subcommittee so acutely aware, of the tension that is developing and perhaps already existing between some small businesses and the higher education community.

This tension is based on the concern that colleges and universities, by virtue of their tax-exempt status, are competing unfairly with small businesses in some areas.

I submit that this tension is unhealthy and it certainly represents an issue that needs to be addressed.

Today, I want to talk about the special role that I believe higher education has in our Nation and about some dire funding realities that are facing our colleges and universities. And I want to begin by saying that America's colleges and universities are in trouble, severe financial trouble.

Now, I believe that where colleges and universities engage in commercial activities that are unrelated to their basic mission as an educational institution, they should pay taxes.

As you know, colleges and universities are subject to a corporate tax on business activities that are unrelated to their exempt education and research functions. In fact, colleges and universities presently pay this tax on income generated by such unrelated activities as hotel accommodations, computer equipment, or athletic facilities used by the general public.

Many colleges and universities do not engage in such income-generating activities, but they do provide important support services for students and they do it at the lowest possible cost. And in many cases, it is the provision of these essential support services that are the subject of your efforts today.

I know you understand that the unique mission of colleges and universities is important to the vitality of our economy as well as to the lives of our fellow citizens. This mission is essential to our development as a nation. Our postsecondary institutions educate our citizens, explore new areas of knowledge and learning, pave the way for our healthy existence in the future, and they develop the skills and culture that has made the United States the envy of the world.

No other entities, none, perform these functions as effectively as do America's institutions of higher education.

Now, all of that costs money and colleges and universities have to continually search for creative ways to finance their activities. They continue to rely on their traditional sources of revenue, such as tuition, State support and gifts. Admittedly, they are trying to develop new ways to raise revenues. Yet the look that I have taken on this does not indicate to me any evidence that traditional patterns of non-profit support have been abandoned by higher education.

Those traditional patterns continue to be the way most colleges and universities raise their money.

Mr. Chairman, it is important to note that Congress has a proud history of supporting the goal of making college available to all who have had the desire and ability to pursue it but who were prevented from doing so simply because of a lack of finances.

An important component of this goal is our commitment to keeping the cost of higher education and the amount paid by students as low as possible. To do otherwise is to risk denying access to bright and capable Americans whose education, of course, benefits all of us.

This past fall, my PostSecondary Education Subcommittee conducted hearings on the all-too-familiar theme of rising college costs. Some of the reasons for increasing costs are similar to those burdening small businesses. Rising labor expenses, the need to comply with new and sometimes complex Federal regulations, the price of energy, building materials, and, of course, the cost of mandated employee benefits all contribute to increasing college costs.

In addition, colleges and universities must purchase unique and costly materials and equipment that are essential to education, such as state-of-the-art science equipment, research laboratories, teaching materials, limited edition library books, and most recent publications. All of that and more have pushed the university and college CPI higher than the CPI that the rest of us know about.

Furthermore, there were changes contained in the Tax Reform Act of 1986 that, in some cases, have added directly to the cost of education. Changes in laws affecting charitable giving now make it harder for higher education to raise money, and the taxation of significant parts of scholarships at a time when our Federal support is not keeping up with education costs requires colleges and universities to raise more money to provide additional scholarship funds to students who are finding that they are receiving less Federal aid.

The Tax Reform Act also limited the availability of tax-exempt financing for facilities and even denied it to some of our Nation's larger research institutions, and that increased the cost of building or rebuilding. And we have not been able to increase our support to students and their families to meet these rising college costs.

In 1985, the committee will remember, we eliminated the social security benefits payable to students, and, thus, we reduced critically-important funds to many needy students.

The Higher Education Amendments of 1986 reduced the authorization for higher education programs by more than $1 billion.

I will say it again, our colleges and universities are in trouble, severe financial trouble.

In the face of rising costs, colleges and universities have tried to keep student expenses as affordable as possible by making available necessary housing and books and food and support services in the most inexpensive manner.

Some run campus bus services, fast food restaurants, some provide computer manufacturers' discounts to students, operate bookstores, and campus health facilities, and provide on-campus child care. These are not activities designed to make money. I think they represent thoughtful and creative attempts to keep education accessible and affordable to struggling students.

Mr. Chairman, I recognize that this is a tightrope. Our small businesses have an obligation and, of course, a right to operate in an atmosphere where their ability to compete is not unfairly hindered by non-profit institutions offering the same services they could offer for no other reason than to make money.

I urge this committee, as you consider this matter, to look closely at whether or not the colleges and universities are offering the services they offer to assure themselves additional capital or whether they are offering services to keep the costs down to the students.

Mr. Chairman, as always, we appreciate your leadership on this and other small business matters, and I am particularly grateful to you for allowing me to appear preceding the next panel.

Chairman LAFALCE. I thank you very much, Pat.

As usual, you have given a very balanced and reasonable and knowledgeable presentation on behalf of the postsecondary educational community. They are in your debt and we are in your debt.

As you point out, though, there are difficult problems and we have to walk a fine line, and my disposition is, of course, educational institutions and charitable institutions are extremely important. Small businesses are extremely important, and we have to ensure that the perspective of the small business community is heard by all. That is one of the reasons we are having this hearing.

The point, though, is if there is competition between these two groups and the activities of the exempt organizations and educational institutions are unrelated to their educational mission, then, in a sense, the small business community would be subsidizing those activities, and I do not think the small business community should be subsidizing those activities.

If those activities are going to be subsidized, it should be by the community at large. When I say the small business community is subsidizing it to the extent that that non-profit enterprise, because of the difference in tax treatment, is taking business away from the small business community, to that extent, the small business community is subsidizing that activity.

So, I do not know personally to what extent all these charges are true or not true. This is really a fact-finding hearing.

I do know that Chairman Jake Pickle is very concerned about this at the Ways and Means Committee, and will have recommendations about it. I really thought that this committee should get off its feet on this issue, especially since this was one of the primary concerns of the White House Conference on Small Business. As I recall, it was their third priority concern.

There is considerable debate on this issue. This debate is probably going to reach the Floor of the House of Representatives at some point, and I hope that we can come up with an equitable resolution of the competing interests.

I do not have any questions. Do any members of the committee have any questions?

Mr. McDade.

Mr. McDADE. I have no questions, except to thank you for coming in, Pat, and your statement, as always, was excellent and we are glad to receive it.

Chairman LAFALCE. Thank you very much.

Mr. WILLIAMS. Thank you, Mr. Chairman.

Chairman LAFALCE. We will now hear from the other witnesses. We will try to have you sit in order. We will have Mr. Joseph O'Neil and then next to him we will have Mr. Mathew Ahmann, and then Mr. John Motley and Ms. Geneva Johnson and Mr. Earl Hess and Mr. James Scott and John Satagaj and Mr. Caspa Harris.

[Pause.]

Chairman LAFALCE. Now, I know we have a lot of witnesses, but just imagine how many witnesses we would have had if I would let everybody testify that wanted to. There will be a great many organizations and individuals submitting prepared statements for the record, but we have the chosen eight today.

Because we do have so many witnesses, ladies and gentlemen, I am going to have to be very strict. You just cannot go beyond 10 minutes and if you can do it in less, if you could do it in five, that would be preferable, because then we can get to the question and answer period and get into the discussion and debate period. If you should go beyond 10 minutes, we will have to stop you.

Mr. O'Neil, chairman of the Business Coalition for Fair Competition.

What do you have to say on this issue?

TESTIMONY OF JOSEPH F. O'NEIL, CHAIRMAN, BUSINESS COALITION FOR FAIR COMPETITION

Mr. O'Neil. Thank you, Mr. Chairman.

My name is Joseph O'Neil, and I am chairman of the Business Coalition for Fair Competition, BCFC.

The BCFC was established in 1983 to promote fairness in the marketplace where the tax-paying and non-profit entities compete. More than two dozen national trade associations and several regional organizations and some small businesses comprise our coalition.

In all, BCFC represents more than one million small businesses.

These are some of the disparate small business sectors that are represented in the BCFC, all of them, by the way, experiencing competition from commercial non-profits: Nurserymen, blood laboratories and providers, consulting engineers, testing laboratories, orthotic and prosthetic dispensaries, travel agents, veterinarians, software storage, health clubs, medical equipment distributors, audio-visual stores, computer firms, hearing-aid dispensers, office product stores, tour operators, professional service concerns, textile rental firms, and bus companies. And we know of other concerned small businesses whose associations have not yet joined us.

Mr. Chairman, on behalf of these hundreds of thousands of small businesses, we commend and thank you for holding these hearings.

The BCFC is convinced that commercial activity by non-profit entities is unfair and is a serious problem for small businesses, that the present Federal tax laws regulating the non-profit sector are woefully inadequate, and that a new way of treating non-profits is urgently needed in order to bring deserved relief to your constituents, U.S. small businesses.

I have submitted in advance of these hearings a more complete statement of BCFC's position on the matter of non-profit competition with small business, and in the time allotted to me this morning, I will focus on the three points cited above.

First, commercial activity by a non-profit entity is inherently unfair and greatly disadvantages the small business forced to compete with it.

Allow me to illustrate this thesis by comparing some of the costs borne or foregone by these competing entities in a typical business year. We assume in this illustration that the non-profit is in the 501(c)(3) category of the Tax Code. This is the largest and fastest-growing and most commercialized group of non-profits.

It includes educational institutions, health care providers and organizations that test for the public safety. It must also be kept in mind in this illustration that laws do vary from State to State.

But let us assume that both entities are expanding, the for-profit and non-profit. The double standard comes into play when they buy new equipment and furnishings worth, say, $500,000. The small business pays a 5-percent sales tax, $25,000. The non-profit is exempt. It pays nothing.

Then, both competitors conduct a mass mailing to 10,000 clients or potential clients. The small business pays $1,670 in postage, the non-profit pays one-half of that, $820. Another $820 saved.

Both firms have successful years and net $100,000 after costs. The small business pays $33,000 in Federal tax, $7,000 in State and local tax. The non-profit is exempt. It keeps the entire $100,000.

State unemployment taxes amount to $5,000 for the small business. The non-profit opts not to participate in the unemployment program but to self-insure in that area and saves $5,000. An option, by the way, that is not allowed to the small business.

The difference at the end of the year: $70,820 in tangible advantage to the commercial non-profit. Beyond that lies another more substantial, albeit more intangible, advantage. There is a public bias toward the commercial non-profit, which is perceived ipso facto as more reliable, more trustworthy, of a higher quality.

The perception is false as often as it is true, but perceptions are real and the small business must live with this unfair marketing disadvantage.

Mr. Chairman, these are not business advantages that the non-profit competitor has earned.

Chairman LaFalce. Just let me interrupt you for a minute, Mr. O'Neil.

Mr. O'Neil. Yes.

Chairman LaFalce. It is my intention not to recess because of the number of witnesses. If there are members who want to go over immediately for a vote, please get back quickly so you can occupy the Chair so I can go over and vote and we can keep going.

I hate to do this, but otherwise we will just have to recess.

Mr. O'Neil. I was just saying that beyond these tangible dollar advantages, there is perhaps the most significant advantage enjoyed by commercial non-profits, which is intangible but real; and it is this public perception that because it is a non-profit, even though in this case it is in the commercial marketplace, its goods are better, it's ipso facto more reliable, more trustworthy and all those good things.

And the fact is that the perception can be false. I do not have odds, but let us say false as often as true, but, nevertheless, this is a real perception and it is a real marketing advantage when the non-profit is competing with the small business.

The thought also should be kept in mind that these are not business advantages that the non-profit competitor has earned, but they are granted by Government and they endure year after year, like a tide that relentlessly erodes the competitive base of the small business in the same market.

My second point, Mr. Chairman, is that the present tax laws are unequal to the task. They cannot create a level playing field in the competition between commercial non-profits and small businesses.

In 1950, Congress instituted UBIT, the Unrelated Business Income Tax, in an attempt to eliminate this unfairness that I have just cited. With all due respect to the good intentions of those Congressmen in 1950, the objective observer must declare that UBIT is a failure for two reasons.

In the first place, even if UBIT were working, it addresses only one part of the inequity problem we have described. Requiring a commercial non-profit to pay Federal taxes on its unrelated business income leaves untouched the other advantages that I cited: Exemption from State and local taxes and sales taxes, deferred postal rates, the option to avoid unemployment compensation fees, and, above all, this non-profit "halo."

In the second place, UBIT is not working.

Chairman LaFalce. Maybe you should change the name non-profit to something else.

Mr. O'Neil. "Non-taxpaying" would be preferred.

In the second place, UBIT is not working. Conclusive testimony to this fact was provided by Mr. Robert Brauer, Assistant IRS Commissioner for Exempt Organizations, at UBIT hearings on May 9, 1988, before the House Ways and Means Oversight Subcommittee.

Mr. Brauer stated unequivocally the substantially-related test, which is the linchpin of the regulations, is not working. "My agents are saying that they are continually losing ground in the battle to collect UBIT taxes," he stated.

My third and final point is the corollary to the second. Because UBIT is seriously deficient, a new approach is needed. The rationale for and basic design of the new approach was described by two scholars of the non-profit sector at the June 1987 Oversight Subcommittee hearings, and I will quote at little length from one of those two people.

Professor Henry Hansmann of Yale University said:

> In determining the wisdom of granting an exemption to commercial non-profits, for example, hospitals or nursing homes, the critical question is whether the non-profits in question provide the kind and quality of service that is unavailable from for-profit firms in the same industry.
>
> If they do not, then the case for tax exemption is quite nebulous. In such circumstances, granting the tax exemption to a non-profit firm will not produce services that would otherwise be unavailable. At most, it will simply produce a larger volume of services at lower costs than would otherwise be available, and if this is what is desired, then we must ask why do we not extend the tax exemption to the for-profit firms as well.
>
> If the industry is reasonably competitive, and most industries in which non-profits have any substantial presence appear to be reasonably competitive, then benefits of the exemption should be passed on to consumers who will buy from for-profit firms as well as from non-profit firms.
>
> In short, the only circumstances in which tax exemptions for non-profit firms in such industries seem warranted are those in which: (1) The patient service that is being provided by both the non-profit and for-profit firms is thought for some reason to be undersupplied and thus in need of a subsidy, and (2) the industry is not sufficiently competitive to ensure that the for-profit firms will pass through the tax exemptions to consumers in the form of lower prices.
>
> It is not obvious that any industry in which commercial non-profits play an important role satisfies these conditions.
>
> It is, therefore, very difficult to justify tax exemptions for non-profits in those circumstances where they do not provide services that are any different from those provided by the for-profit competitors.

Mr. Chairman, BCFC believes that Mr. Hansmann's theory makes sense in our free enterprise system. The Government should not subsidize some competitors in the business marketplace to the disadvantage of the other competitors, unless it can be demonstrated that the subsidized competitors are providing a service to a substantial number of clients whose needs would not otherwise be met.

Absent this, all competitors should bear the same business burdens. Otherwise, competition is neither healthy nor fair.

Thank you for this opportunity to present the views of BCFC.

[Mr. O'Neil's statement may be found in the appendix.]

Chairman LaFalce. Thank you very much, Mr. O'Neil.

And, now, Mr. Mathew Ahmann, the associate director of Government Relations for Catholic Charities, and chairman of the Independent Sector Task Force on UBIT.

TESTIMONY OF MATHEW AHMANN, ASSOCIATE DIRECTOR, GOVERNMENT RELATIONS, CATHOLIC CHARITIES USA, AND CHAIRMAN, INDEPENDENT SECTOR TASK FORCE ON UNRELATED BUSINESS INCOME TAX

Mr. **Ahmann**. Thank you, Mr. Chairman.

Let me join with Joe O'Neil in welcoming the attention of your committee to the relationships between the non-profit sector and the commercial sector of our economy.

Non-profits are subsidized by for-profits and small businesses, by voluntary contributions from those businesses, and by the tremendous amount of leadership provided. The non-profit world simply could not function without the participation and the leadership roles of the non-profit and for-profit business men and women.

I would like to make a quick comment on Mr. O'Neil's remark relative to the research and writing of Henry Hansmann on the concept of commercial non-profits. Mr. Hansmann is one of a limited number of people who are really trying to puzzle out what has happened to non-profits as the Government has been very much involved in social policy and extending the services of those non-profits as, for example, Medicaid–Medicare in the hospital world.

But Mr. Hansmann continually hedges his observations, cautions, never makes a flat-out assertion, though he raises very important questions.

The difficulty with the concept of commercial non-profits is that it is too easy. It is a look-alike concept and it does not really give you a chance, if you are not very familiar with the world, of evaluating what might be the differences between that non-profit entity and the for-profit entity.

I can tell you from my own experience. I was born in St. Cloud Hospital on the banks of the Mississippi 60 miles north of Minneapolis. The hospital was founded by Benedictine Nuns. That hospital is not leaving the community because of the impact of the DRG's and Federal cutbacks in health spending, though some of the for-profit chains are beginning to sell off their operations as they are meeting difficulties.

So, I think there are a lot of serious questions to look at as you look at the impact of Government policy on non-profits, and as I say, Mr. Hansmann does a very interesting job of that.

Chairman **LaFalce**. I am going to have to interrupt. I was hoping somebody might return, but I think if we leave now, we will just have enough time to make that vote.

So, we will have to recess either until I return or until another member returns who has already voted.

So, the committee will recess temporarily.

[Recess.]

Mr. **Bilbray** [presiding]. Our witness is Mr. Ahmann, associate director, Government Relations of Catholic Charities, USA.

Mr. **Ahmann**. Mr. Chairman, I want to make five or six very quick points that are excerpted from my statement.

First of all, it ought to be understood when one thinks about the economic activity of non-profits that from 1982 to 1986, according to the studies done by Mr. Lester Salamon of the Urban Institute and Johns Hopkins, non-profits, if you set aside Medicare and Medicaid, have lost $100 billion in Federal revenues. They face very tough economic times.

Despite that, in the last several years, there has been this high level of attention to what is called the unfair competition debate. Despite the six days of hearings in Mr. Pickle's subcommittee and a variety of conferences here and around the country, all of this debate produced very little, if anything, about the nature and extent of the unfair competition problem.

If there is one thing that is agreed upon in the non-profit community and in the small business community, it is that we need the support of Congress for significant improvements in data collection so that you can study the interaction between the two.

There never has been question in the U.S. census. Every 10 years, we have a census. There has never been a census question which has enabled us to sort out non-profit and for-profit employment and all the other kinds of data that flows in the decentennial census.

Second, we need improvements in IRS form 990. We need public tabulation and publication of the 990 data and so on. I have the recommendations in my statement.

Third, I would like to deal with this vague notion that has been called by one Member of Congress, the $300 billion revenue foregone issue. We now can pretty well agree there is an estimate of $300 billion of income in the non-profit sector, but as Treasury indicated yesterday, there is really not very much potential tax money in that income.

On page 11 of the INDEPENDENT SECTOR testimony (Treasury itself uses the same data gathered by INDEPENDENT SECTOR) we break down the $300 billion. Private contributions, 26.9 percent. Government grants and payments, 26.9 percent. Health services payments, 24 percent. Tuition, 12 percent. Investment income and endowments, 5.5 percent. Other dues, fees, and charges, which includes a lot of fees for services in the social service community, all those, 4 percent or so.

So, there is not very much taxable income in the non-profit community, at least given current law or what is presently pending before the Ways and Means Committee.

Finally, I would like to say a word about fees for service, which have a kind of vocabulary problem. Joe calls them sales and we call them fees for service.

This is when someone comes in to my Catholic Charities agency and they need some family counseling, and we have a discussion about their income situation and we agree with them on a fee to charge them on a sliding scale to help pay for the costs of their counseling.

We do not think it is appropriate to consider that a business sale in the same sense that you would in the small business community because a lot of other considerations besides straight sales go into it. Non-profits generally subsidize a tremendous part of their activities through other sources of funds, Government, or contributed funds.

I am going to leave my remarks there and you can go on to the next witness.

[Mr. Ahmann's statement may be found in the appendix.]

Mr. BILBRAY. Mr. Motley is next, please.

TESTIMONY OF JOHN J. MOTLEY III, DIRECTOR, FEDERAL GOVERNMENTAL RELATIONS, NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Mr. MOTLEY. Thank you, Mr. Chairman.

First of all, before I get into summarizing my statement, I would like to thank the chairman and the ranking minority member and the committee for continuing to pursue the recommendations of the 1986 White House Conference on Small Business.

I think that the small business community of this country is very much aware of the fact that the committee has held a whole series of hearings on those recommendations and is very grateful for it and is also very grateful that the committee has chosen to take a look at this very important issue.

I think that there is nothing really that would make the hair on the back of a small business owner's neck stand up more than to hear that in some way that his or her tax dollars were being used to help subsidize somebody who is competing with them, either direct subsidization, which is the Federal Government competing in many different areas, or indirect subsidization through certain different tax advantages or other types of subsidies which could be given.

The problem with this type of competition from the small business owner's standpoint is, number one, that they believe it is unfair competition, and I believe Joe gave one example and we could probably come up with several more if the committee wished to have them.

But, also, I think from the small business owner's standpoint is that one of the concerns they would have is that it also tends, if the competition is successful and drives some smaller businesses out of business, it tends to reduce the tax base of the locality, which increases the tax burden for everybody else in the locality.

Small businesses are generally the backbone of local economies, the backbone of the local taxpaying part of that economy, and if the small business tax base is reduced, then the locality has to look to other areas to raise money or to increase the burden on those people who remain.

Non-profits are extremely important to this society. Congress has recognized that for a long time and has moved to take those organizations which are providing charitable and educational benefits to the communities, that were not being provided by others, and to shield them from the effects of the Tax Code.

Starting all the way back in the last century and 1984, when the non-profits were exempt from the corporations tax and the cost was recognized early in this century with the institution of the Federal income tax.

But Congress in recent years has also realized that being exempt from taxes and the other benefits that flow from being exempt from taxes is a very, very powerful advantage for non-profits and, therefore, in 1950 enacted UBIT and then moved in 1969 to strengthen it.

I would agree with the remarks made here already that we do not believe that UBIT is working as well as it should work to protect smaller taxpaying businesses in this country. We also believe that the problem is the interpretation of the substantially-related checks.

For many years, I think Members of Congress and the organizations that are represented up here, representing small business, have heard isolated complaints about competition from non-profits. First of all, it was the bookstores who had to compete with the colleges and universities. Then, it was the testing laboratories and gradually one group of businesses after another began to complain to their Congressmen and to their trade associations that they saw unfair competition.

But these are really relatively few and they are relatively isolated, and I think that they failed to get the attention of the small business community as a whole and certainly failed to get the attention of the Congress for the last couple of decades.

What we have seen and what has brought about the recent concern or the heightening of concern in the area is really an explosion, I think, in the activities of non-profits over the last decade to decade and a half.

The 1987 GAO report, I think, really points this out very, very clearly. In 1975, 39 percent of the funds raised by 501(c)(3) organizations came from business activities or business receipts. Just seven years later, 81 percent of the total funds raised by these organizations came from the same source.

In the same year, in 1982, 51 percent of the total funds raised by 501(c)(4) organizations came from business-related activities.

As I said, the original complaints were relatively isolated and came in more traditional areas. The college bookstores, the testing laboratories. Today, we hear a great deal of complaints about competition from hospitals, non-profit hospitals, and from YMCA's, and, in fact, we have had a number of recent examples, I think, in just the last couple of years of what tends to be the epitome of competition from the non-profit community with for-profit businesses, when you have the Washington Post doing a series of stories on business activities of the AARP, the PTL, and the National Geographic.

In 1984, the National Geographic was a $326 billion a year operation.

I think that the explosion is the reason that you find that this problem becomes the number three recommendation of the White House Conference on Small Business, and it is the reason that you find more and more small businesses by SIC Code getting involved in this particular issue.

The reason for the growth of concern, I believe, has been explained by Joe and that is the tremendous advantages that we believe that non-profits have operating in the commercial marketplace.

The first and foremost, of course, is the Federal tax exemption, but once the Federal tax exemption is granted, a whole series of other benefits tend to flow from it. Such as exemptions from State and local property taxes, exemptions from State sales taxes, exemptions from payroll taxes for universities. The postal subsidy has been mentioned.

Once that initial exemption is received, then the non-profit receives a whole series of other benefits which enable it to compete, we believe, unfairly in the marketplace.

On pages 5 through 11 of our statement are the results of about a year and a half's communications with our membership in which we have been collecting information on the types of non-profit competition NFIB members have been experiencing.

We have given examples. Of course, there are more details of those examples if the committee wishes to have them. I simply call that to your attention.

The heart of the problem, though, we believe or appears to us, is the substantially-related test. The current substantially-related test in its broad judicial interpretations are, in large measure, we believe, responsible for much of the uncertainty which exists in the non-profit statutes and have resulted in a large number of commercial activities of non-profits. NFIB would have a certain number of recommendations to this committee and has also made them to the Ways and Means Committee in the work being done by Congressman Pickle and Congressman Schulze, to help clarify that and help make it work better.

We believe that a clearer standard to determine what is substantially-related is needed. That standard should contain a clear test to determine when a commercial activity is taxable under the UBIT statute. It should be sufficiently flexible to take into account transactions and situations we feel will certainly evolve in the future, and it should require the prequalification of each commercial activity vis-a-vis non-profit status.

The second recommendation is that subsidiaries must be capitalized. Subsidiaries of non-profits must be capitalized, financed and operated at arms length as third-party organizations. The standard must be such that non-profit organizations cannot simply evade their responsibility by shifting ownership among friends.

Third recommendation is that for any reform to be successful, the IRS must be in a position to know which entities are related to the non-profit. Expanded reporting rules are necessary to require the non-profits to identify those organizations in which they have an interest.

And our last recommendation, Mr. Chairman, is that there should be a segregation of profitmaking activities similar to the pass of loss rules enacted under Tax Reform. This rule would prevent one loss subsidiary from offsetting losses against a profitable one.

Essentially, this recommendation would instill some economic concerns in the management of the non-profit parent.

Chairman LaFalce. If we go that way, then we are going to have to make it simpler than the rules regarding active and passive income. They are too complex.

Mr. MOTLEY. I do not think we have any disagreement on that, Mr. Chairman.

Let me simply conclude by saying that we at NFIB and obviously everybody within the small business community believe that this issue is one of growing importance, and it needs to be addressed before it undermines the vitality of certain sectors within the small business community and also I think from the small business owner's standpoint undermines the local tax base which, if that happens, will, indeed, increase the burdens upon everybody who is left.

Therefore, I commend the committee for taking an interest in this and for being willing to work with everybody to try to come up with some solutions, and we stand ready to work with you in the future.

Thank you.

[Mr. Motley's statement may be found in the appendix.]

Chairman LAFALCE. Thank you.

Our next witness is Ms. Geneva Johnson, the president and chief executive officer of Family Service America, and she is testifying today on behalf of the National Assembly of National Voluntary Health and Social Welfare Organizations.

Ms. Johnson, we are delighted to have you with us.

TESTIMONY OF GENEVA JOHNSON, PRESIDENT, FAMILY SERVICE AMERICA, ON BEHALF OF NATIONAL ASSEMBLY OF NATIONAL VOLUNTARY HEALTH AND SOCIAL WELFARE ORGANIZATIONS, INC.

Ms. JOHNSON. Thank you very much.

Good morning.

Our organization, Family Service America, is a voluntary organization which has been serving families in North America for over 77 years.

Also with me this morning is Janne Gallagher, who is the counsel to the Grants and Contracts Project, and is the co-author with Harrison Wellford of the forthcoming National Assembly publication, "Unfair Competition: The Challenge to Charitable Tax Exemption."

Today, I am representing two umbrella organizations, the National Assembly and the Grants and Contracts Project, and the membership list of both national organizations is attached to our statement.

Our primary reason for being here this morning is to provide the committee with information about human service non-profits, what they do, how they are supported, and why they are exempt from income and property taxation.

Our testimony reflects the results of the study of these non-profits, the results of which will be published next month in the book, "Unfair Competition."

Before turning to the main focus of my testimony, however, I would like to dwell a moment on two very important points.

First, non-profit human service organizations depend on the generosity of many small business executives who serve as board members and contribute their time, energy, and money to supporting charitable activities in their communities.

Second, through services provided to the whole community, rich and poor, charities make communities a better place to live and work, where businesses are able to recruit and maintain a productive workforce and operate in a safer and more congenial environment.

For human service organizations, tax exemption including exemptions from State and local property and sales tax is by far the most important of the benefits conferred on non-profit organizations.

The tradition of tax exemption for charitable activities is very strong in America and has its roots in Elizabethan England.

It should be noted that this Nation is more than any other nation in the world a three-sector society. There is a delicate balance at work in which our country is strengthened by our tax system, which allows for problem solving not only by Government and commerce, but also by organized groups of citizens known as voluntary associations.

What is a non-profit agency? Human service agency? Human service providers are those non-profit organizations that assist the growth and development of individuals and families and help them address crises in their lives. They are citizen-led organizations, such as the American Red Cross, Boys Clubs, Girls Clubs, Salvation Army, Volunteers of America, Boy Scouts, Girl Scouts, Goodwill Industries, family service agencies, child welfare agencies, YMCA's, YWCA's, United Way, Catholic Charities, Jewish Federation, Lutheran Services, and other similar organizations that provide services in every community across America.

These organizations are a part of community infrastructures throughout the Nation.

Most human service not-for-profits are local community organizations. They are governed by local volunteer boards of directors which are composed of leaders from the community.

In a very real sense, human service agencies are owned by the communities they serve. Included among these community leaders who serve on human service agency boards are, of course, small business executives. They are among the volunteers who share the role of providing guidance and priority setting for the human service agencies.

A year ago, Frank Swain of the Small Business Administration told the Ways and Means Oversight Subcommittee that the relationship between many non-profits and for-profits is very close, and we agree with this judgment.

Human service agencies under the guidance of volunteer boards do much to strengthen and improve the community environment that enhances opportunities for small businesses. These agencies help families and individuals having problems with drugs, child abuse, family disruption, alcoholism, and so forth.

Services are made available to all based on the ability to pay on a sliding fee scale. Young, old, affluent, and poor, single parents and minorities are all served with dignity and respect in the same not-for-profit human service agency.

Recent concern expressed by small business communities have led to efforts on the part of human service agencies to convene meetings with such business men, both in Washington and at the local level.

In addition, a manual was prepared to advise non-profit human service agencies on the expectation of the Federal law regarding the payment of unrelated business income tax. This was widely distributed.

Family Service America, for example, mailed this document to its entire membership.

Human service organizations also have supported several of the changes of the Federal tax code recommended by the Ways and Means Oversight Subcommittee. We do support most aspects of the subcommittee's proposal, including the following: Retention of the substantially-related test, improved tax reporting with regard to revenue-producing activities and income, the increase in the UBIT deduction and the threshold for filing with a phase-out beyond $50,000, applying UBIT to certain health and fitness activities unless the program is available to a reasonable cross section of the general public, taxing royalties that are measured by net or taxable income, modifying the definition of a controlled subsidiary, and more rigorous enforcement of the substantially-related test.

A word about fees for service income. Some misunderstanding has been expressed by the business community concerning the practice by non-profits of charging fees for service. Most human service non-profits charge fees according to the client's ability to pay.

Fee for service income is not a new source of revenue for human service non-profits. It has been an integral part of their operations for more than 100 years. The poor pay little or nothing, the better-off pay proportionately higher fees. Others charge a flat fee but provide scholarships or other means of financial assistance to those who cannot pay. Some agencies simply ask clients to pay what they can.

Paying a fee when one can lends dignity, self-respect, and self-determination. It teaches young people responsibility and some agencies believe that paying what one can is an essential part of the help being offered.

Some myths concerning the human service agency. There is a myth that not-for-profit organizations were formed to operate entirely on donated dollars. In fact, human service charities have always relied on a combination of Government funding, private contributions, membership dues, and fees for services rendered.

A second myth asserts that charging fees provides a huge income for non-profits. In fact, data indicates that fee for service income in 1984 was 12.6 percent of the total income, and those fees were used to support other programs within the agency and not considered as surplus.

The third myth claims that charities are becoming more commercial and competitive. There is no data to support this allegation. A recent United Way survey indicated that only 7 percent of human service non-profits funded by the United Way filed IRS forms 990T's, and only 3 percent of those surveyed had established for-profit subsidiaries.

The survey also found no evidence of a lack of compliance with current IRS filing requirements.

The fourth myth alleges that unfair competition exists in our society between non-profits and for-profits. There is no reliable data that exists to support this position. In some instances, there are going to be non-profits and for-profit organizations offering similar services, such as child care or family counseling.

However, the fee structure is likely to differ as to the accessibility of the poor and near poor for such services, and these programs operate under the supervision and guidance of community boards composed of volunteers.

In our opinion, such services offered to the communities do not constitute unfair competition.

The fifth and last myth argues that there is a clear cut distinction between commercial and noncommercial services. The dichotomy does not reflect the real world. Almost any service offered by a non-profit agency could also be offered in a for-profit setting. This does not make the service offered by the non-profit commercial.

The real issue relates to the structure of the three-sector society. In our Nation, we have entities which offer services to the community, not to generate profit, but, rather, to meet the goals set by citizen boards to promote healthier families, individuals, and communities.

Those goals are served in a different manner when the profit is the primary motive. A commerciality standard would turn on its head nearly 400 years of common law and legislative precedent.

The test for tax exemption has always been whether the aims and goals of the charity provided a public benefit and whether the charity's assets are devoted to accomplishing those goals.

And, in conclusion, various tax policies, both Federal and State, appropriately support both non-profits and small businesses. We do not believe that the solution to problems that have arisen lies in adjustments to the tax code or the imposition of bureaucratic procedures on small non-profit organizations.

Rather, we believe that the solution lies in small businesses and non-profits working together at the local level to identify problem areas and to try and find ways in which both can continue to offer vital services to their communities.

Thank you.

This concludes my testimony.

[Ms. Johnson's statement may be found in the appendix.]

Chairman LaFalce. Thank you very much, Ms. Johnson, for your fine presentation.

Our next witness will be Dr. Earl Hess, a member of the Board of Directors of the United States Chamber of Commerce.

Dr. Hess.

TESTIMONY OF DR. EARL H. HESS, MEMBER, BOARD OF DIRECTORS, U.S. CHAMBER OF COMMERCE

Dr. Hess. Thank you, Mr. Chairman, for this opportunity——

Chairman LaFalce. Did you testify before on some issue?

Dr. Hess. I think I have been around before on this issue. I also testified about three weeks ago on child care.

Chairman LAFALCE. Oh, before the Small Business subcommittee? You look familiar.

Dr. HESS. Yes. I have been around for awhile on other issues, too.

Let me say, first of all, that I appreciate the opportunity to testify before you this morning. Even though none of you is from my congressional district, I really do feel like a constituent of the entire group here. I appreciate the very fact that the Small Business Committee does exist and you are willing to take hold of a knotty problem like this and give it some exposure.

I guess as I look around the panel, I recognize that I am the only participating entrepreneur founder of a small business in this crowd, unless there are some people in the non-profit sector here that identify themselves that way that I do not know.

So, I would like not to dwell so much on the prepared statement which I hope you will be willing to enter into the record, but give you some personal reflections as to how it feels to experience this problem in the pit of one's own stomach and also some reflections as to what I think might be done about it.

About 27 years ago, I chose to break ranks with the conventional and establish my own business, as a chemist in private practice at that time because my business was extremely small. I do not know whether I was prophetic or just a rebel. Later on, John Naisbitt came to talk about the societal trend towards switching to a high-technology information society, and I guess really that is what Lancaster Laboratories is all about.

We have grown over that period of time to a staff of about 250–260 people and are still growing rapidly, providing services in the chemical and biological sciences relating to environment and food and that sort of thing.

The question that would immediately arise, I suppose, is that if you have a problem with non-profit competition, how can you be as successful as you are? I can say that we encountered university competition within a year after we were in business. It almost put us under so that we had to change our business plan significantly, not realizing how many of the services we were planning to provide were really being provided on a commercial basis by the university.

But back to that question of why I am successful. Small business persons are generally very persistent, maybe working harder and smarter in order to counter the unfair competition that exists. I would also like to point out that I am in a business in which there is presently a very rapidly-growing market, and, therefore, if I lose a contract or a bid to a non-profit, there is always another one there to be had.

Within the last year, I have lost a $400,000 contract to the University of Iowa for work that is strictly commercial in nature. I would be much more upset about this and I think you would, too, if I were forced to lay off 10 or 15 people as a result of that. The market is expanding rapidly, but that is no excuse for such to be happening. It simply explains why, through our efforts, we are still able to grow rapidly.

Mr. MCDADE. I want to get through the panel, but you focused on an issue there in front of the committee and that was your position as an entrepreneur vis-a-vis a non-profit in what you believed to be a commercial area of research and losing to the non-profit.

Can you flesh that out a little bit for the committee? What kind of a contract were you bidding? What was the service that you say that was fully commercial?

Dr. HESS. This was a service for a commercial testing of environmental samples, a request for proposal or bid put out by the U.S. Army, Environmental Group, at Aberdeen, MD. Strictly commercial. Absolutely.

Mr. MCDADE. What did they want? What was the RFP requesting?

Dr. HESS. Requesting simply analytical support. The question of qualifications was already resolved. Each of us had to analyze proficiency samples, undergo a laboratory inspection to be sure that we were qualified; then it was simply on a low bid basis, and you will find the University of Iowa listed as a contractor in the Superfund program presently along with other private companies.

It is an interesting——

Mr. MCDADE. And are you able to say to the committee that you lost that contract because of a disadvantage on——

Dr. HESS. Price.

Mr. MCDADE [continuing]. Price resulting from a non-profit vis-a-vis the profits?

Dr. HESS. Very definitely, and I have lost several more of them to that same entity. In my testimony to the Ways and Means group, I cited the University of Iowa as a chief contender. They operate a business that supposedly serves the people of Iowa, in which they are uniquely qualified to serve.

I do not think a Federal Government contract serves the people of Iowa or, for that matter, are they providing anything for which they are uniquely qualified.

Mr. MCDADE. Thank you for answering the question.

Dr. HESS. I am here today representing the U.S. Chamber as a member of its board of directors, and I would like to acknowledge the presence of Chris Russell, our new director of its Small Business Council, whom I know that you all know, and Nancy Fulco, who is here with us as well.

My path to the chamber board seat has proceeded through a series of local chambers and State chambers, and I think that some of my background is identified in my formal statement. I have also been president of our national trade association, the American Council of Independent Laboratories, and, incidentally, chaired the Pennsylvania delegation to the 1986 White House Conference on Small Business. Our delegation was a very strong proponent of the number 3 recommendation.

I would like to go on and say, though, that my involvement is simply not with the trade associations. I have been involved as a volunteer on many 501(c)(3)'s—presently serve on a seminary board, served on the board of a non-profit retirement home and that sort of thing.

The point I would like to make is that the solution to this problem is not nearly as difficult as some would have us believe. There exist, in my opinion, relatively few blatant abusers who put out a smoke screen, characterizing those of us in small business as myths, using anecdotal material and that sort of thing, as if we were opposed to Girl Scout cookies and church suppers and sometimes even motherhood itself.

Unfortunately, in the world of politics, these smoke screens seem to work pretty well.

Chairman **LaFalce**. We can stipulate that Girl Scout cookies are OK. OK?

Dr. **Hess**. I eat them all the time.

Chairman **LaFalce**. OK.

Dr. **Hess**. I say there is strong evidence that that smoke screen is working because if you look at the study options coming out of the Ways and Means hearings, it seems to be directed all over the place. A lot is directed toward (c)(6) organizations, such as represented by the chamber, of taxation, of advertising income and that sort of thing in a very unfair way.

I can only conclude that if the Ways and Means groups say that this is not a revenue-raising thing, but a concern to solve the problem of small business, that that smoke screen is working very effectively, and we have a lot of things going out there that are almost punitive or just simply revenue-generating.

The chamber itself is a 501(c)(6). Ninety-two percent of its members are small businesses. The other major components are trade associations, local chambers of commerce and the like, most of which have predominantly small business members.

The chamber also has some 501(c)(3) members, although not a very large number.

I want to describe a process through which the chamber has dealt with this issue in the last year and a half.

First of all, the chamber board endorsed recommendation number 3 shortly after the White House Conference, and then a study group (consisting of the Small Business Council of which I am a member, the Association Committee and the Taxation Committee) has looked at all angles of this thing, especially as the Ways and Means hearings have developed.

A paper was developed and approved by the board of directors and is attached as a position statement along with my prepared statement.

I am going to try to glance over very quickly the elements of the written statement. We make three points.

(1) The profile and the rapid growth of non-profits engaged in commercial activities based primarily on the GAO study. (2) The action taken by the business community thus far. I met Chris Russell, in fact, in 1979 when Milton Stewart put together a task force on Government competition and non-profit competition. Through that whole process—the 1980 White House Conference, the formation of BCFC, with the input of Frank Swain and the SBA, the 1986 White House Conference, Ways and Means hearings—here we are finally at least looking at an issue that the small business community is very much concerned about.

(3) The third point we make is the limited capacity of Internal Revenue to enforce, and that goes without saying.

Permit me, in wrapping up, to make a few personal observations. I would like to just enumerate again for the record the competitive advantage of the (c)(3)'s when they are in direct competition with me for commercial activity.

Income tax (Federal/State). In some States, capital stock franchise taxes. (That, UBIT would address to a degree, but not nearly enough.) Property taxes, sales taxes, the whole series of payroll tax exemptions.

Mr. O'Neil referred to unemployment compensation. Our company puts in $50,000–$60,000 a year in unemployment compensation premiums, has never laid off an employee for lack of work, and I could have that $50,000 or $60,000 as retained earnings if I had the options of the non-profits.

Mailing privileges, half the rate. Just think a moment about public service announcements, how many times do we hear ones coming from Underwriters Laboratories or Franklin Institute or the National Sanitation Foundation, which are pure commercial advertisement for their firm rather than ours?

Direct subsidies in addition to tax exemption. Here, I might be treading on some tender ground because I know that you as a small business committee have been supportive of programs of technology transfer, using university resources and that sort of thing, and I am not condemning that by any means.

I am simply saying that when you take such steps, including technology transfer and small business development centers, think for a moment that the aid that is being provided to the small manufacturing business might be unfair competition to the small professional service business.

We have in our State something I know you have heard about, the Ben Franklin Partnership, and I am looked at as some kind of a scoundrel because I have raised questions about areas that are directly competitive with small business such as a university not only getting tax exemption but also getting subsidy through my tax dollars to give it a further advantage in competing with me.

The subtle ones. I would like to give a few examples of what has been referred to as the "halo" effect. I had to look out my office window yesterday——

Chairman LAFALCE. Dr. Hess, I am going to have to ask you to sum it up pretty soon.

Dr. HESS. OK. One minute more.

The question of quality and objectivity. The "halo" is assumed at work. No one ever questions a university's objectivity or capability. Mine is being questioned all the time.

I testified just a few weeks ago about our putting an on-site day care center in our facility. That day care center construction was held up for two months to get a zoning permit issued, strictly because it was going to be a for-profit entity. If we had set it up as a non-profit entity, it would have gone through without any question.

Now, the instance this last week which really hit me between the eyes. I received a call while I was traveling that our day care kids had been using the city park and they were ordered off the park because our day care was a for-profit entity. Could they come back and use the recreational area that was around our laboratory?

I had to look out my window for the last two days seeing 56 kids. The only reason that they had been using those cramped facilities was because their parents had sent them to a for-profit day care center rather than a non-profit.

Now, this thing is going to be remedied. I talked with the Mayor about it already, but there is no reason why we should have to put up with that kind of thing. Day in and day out, the "halo" effect is hitting me right here in the stomach, and I am here to tell you about it.

Thank you very much. I appreciate your broadening this to something other than UBIT.

[Dr. Hess' statement may be found in the appendix.]

Chairman LaFalce. Just out of curiosity, have there been hearings other than UBIT respecting competition between for-profit and non-profits, or is——

Mr. Hess. This is it. And I should say that our testimony was prepared thinking the focus was mainly in UBIT and it hasn't been of that twinge and I tried to broaden it in my oral presentation to you.

Mr. Olin. Mr. Chairman?

Chairman LaFalce. Congressman Olin.

Mr. Olin. I do not want to lengthen the hearing, but the gentleman said that there was a simple solution to this problem. But do I understand you correctly that their solution was to focus on direct, direct grant subsidies rather than tax-exempt? Is that your basic testimony?

Mr. Hess. My solution is——

Mr. Olin. So I understand it.

Mr. Hess. My solution I say is to see through the smoke screen of a few blatant abusers and either have them convert to for-profit status or get out of business. And then the many, many non-profits would no longer be challenged. The problem would go away as far as small business is concerned.

Mr. Olin. You would eliminate the tax exemption of certain entities?

Mr. Hess. Right. I am saying simply to make them pay unrelated business income tax and allow them to proceed is only half the solution.

Mr. Olin. I did not mean to interrupt the hearing, Mr. Chairman.

Chairman LaFalce. I appreciate that.

Mr. Olin. I still do not understand how that would work, but I——

Chairman LaFalce. We will not——

Mr. Hess. It is a very good question.

Chairman LaFalce. It is a good question. We will not have across-the-board questions at this time, however, we are almost there. And then I think we are going to have an awful lot of questions.

Let us go to our three remaining witnesses.

Our next witness is going to be Mr. James L. Scott, the president of the American Health Care Institute.

Mr. Scott.

TESTIMONY OF JAMES L. SCOTT, PRESIDENT, AMERICAN HEALTHCARE INSTITUTE

Mr. Scott. Thank you, Mr. Chairman.

I am here representing the American Healthcare Institute, which is a national network of 34 voluntary not-for-profit multihospital systems.

We, like the other witnesses, appreciate this opportunity to share our views regarding competition between tax-exempt organizations and for-profit business activities.

As you know, Mr. Chairman, throughout our Nation's history the voluntary not-for-profit hospital has been accorded a special status because of its commitment to a broad range of charitable purposes and essential community services.

The goal of the voluntary community hospital has always been to maintain and improve the health status of all the citizens in the community by offering whatever health services are needed irrespective of whether or not the recipient of care can pay or whether the cost of such services can be recovered.

We are proud to be a part of the tax-exempt health community. This community service commitment involves responding not only to the personal health care requirements of the patients we serve, but also major responsibilities for the training of health care professionals and the conduct of research on new and innovative medical technologies and the health education of the community at large.

In a competitive environment, it is not always possible to charge patients an additional amount to pay the cost of community services of non-profit hospitals that go beyond the cost to other institutions.

One of our concerns, Mr. Chairman, is that the Congress not overlook the importance of the not-for-profit health sector in meeting societal goals in the broadest possible manner.

The entities that make up the independent sector serve a social purpose because their benefits go to the community at large. They are publicly-accountable organizations through Government structures that include local community leaders.

Our health systems and their member hospitals are outlets for a wide array of voluntary efforts and have access to philanthropy and less expensive capital only because they serve the public interest and not just the interest of private investors.

Until the late 1960's not-for-profit hospitals met the cost of their community commitments by a combination of Federal and State project grants, the payment for bill charges from insurers and self-pay patients, annual community fund drives and other philanthropy.

With the passage of Medicare and Medicaid, revenues from patient care were improved, but other important sources of operating revenue such as gifts dramatically decreased in importance. Over the next few years so also did special Federal and State project grants except for those destined to tax-supported and publicly-sponsored institutions.

Despite these changes, our hospitals were able to continue to fulfill their community missions supported largely from their incomes from private and public third-party payers.

However, in 1982, Congress changed the groundrules under which hospitals had previously operated when it passed the Tax

Equity and Fiscal Responsibility Act, which had the effect of dramatically reducing our Medicare payments.

In 1983, hospital Medicare reimbursement was changed even more radically when Congress declared that from then on Government would determine the economic value that was to be placed on services rendered in the hospital on behalf of Medicare patients and price these services prospectively. Thereby putting hospitals at risk in what was the equivalent of a commercial marketplace.

Also, employers sought ways to pay only the marginal costs of taking care of their patients or sometimes just a little more than marginal cost.

It was as if these two principal purchasers of care Government and business consider the health care patient that they were responsible for was to be treated like a commodity and someone else should take the responsibility of meeting the needs of other community residents.

To make matters even more difficult, every year since 1983, Medicare and Medicaid have been asked to absorb a disproportionate share of Federal budget cuts.

In 1988, for example, according to the CBO, Medicare which accounts for only 8 percent of Federal expenditures will have to contribute 16 percent of the budget cuts initiated to meet Federal deficit reduction goals, thereby forcing many hospitals to lose money on Medicare patients and to seek to transfer to payers in the private sector the responsibility to make up for this loss.

However, Mr. Chairman, although hospitals' revenues are being constrained, we have not seen any change in the attitude of the public as to what is expected of voluntary hospitals in pursuing our traditional missions.

Indeed, in most communities the public still expects local hospitals to provide a full range of health services irrespective of whether these services are economically viable and to provide those services whether patients can pay for them or not.

In the United States, the competitive environment affects all three sectors of economic activity: Governmental, public, commercial, and the non-profit sector. It is impossible for these three sectors especially in health care to fulfill their functions without having some competition at the margins.

In health care, oftentimes governmental, non-profit, and commercial hospitals will compete directly with one another, in one community, for services to patients.

As I have said, the general public continues to expect us to meet their needs irrespective of whether the services can be self-supporting or the patients can pay for them.

At the same time, the delivery of health care services has been subjected to the constraints of the marketplaces where hospitals compete for patients on the basis of price. It follows that generating new revenue for non-profit hospitals to cover the cost of such activities as education, research, bad debts, indigent care, burn units, neonatal intensive care has become essential.

Generally speaking, the criteria our institutions have used to determine whether or not to initiate a new line of revenue-producing business are two.

The first one is permanence and reliability. You will need to know that the services that we are adding are going to be there on a permanent basis for our patients. The second is control and convenience.

Initiating a revenue-generating activity that meets these criteria leads some to conclude that not-for-profit hospitals have begun to resemble entities in the private commercial sector.

I would submit that very important distinctions remain and that only an understanding of the role of not-for-profit hospitals and society can put that issue to rest. In support of this proposition, I would offer the following points for your consideration:

First, voluntary hospitals almost universally trace their roots to ownership or sponsorship by a religious entity. As such, their missions were to meet a social purpose literally as an extension of Government without being under governmental control.

Second, together with many public hospitals, not-for-profit hospitals are the primary site for clinical research and educational programs for health professionals, including but not limited to, physicians, nurses, and other allied nurse professional personnel.

Third, many features characterize the contemporary not-for-profit hospital. The first one I've mentioned before is, we provide care to all individuals no matter what their financial circumstances. And, two, and very important, we meet the full profile of health needs in the community, including but not limited to things like burn units, trauma centers, neonatal intensive care, health promotion—services which are vitally necessary to a community but are not economically self-supporting.

Next, we provide the sites for the development phase of much of the new medical technology, and finally, I think this is very important, service outlets for personal philanthropy and volunteerism, and as sources of reinforcement for other community voluntary entities.

Finally, almost 30 years ago, the American public first declared for itself the social aspiration that access to health care should be a right. By common consensus, there is no way in which Government today can implement such a broad and desirable social objective.

The Government has been able to contemplate this objective but has been wholly and totally dependent upon the existence of a private non-for-profit hospital sector.

Mr. Chairman, it is our summary position that in a pluralistic and multi-faceted society such as ours, there will be conflict and overlap between governmental, non-for-profit and commercial sectors. In other words, some competition is inevitable. Making the competition fair, consistent with permitting each of the elements of the three sectors to pursue their primary objectives, is a popular objective. In this context, it is our judgment that the principles contained in the current tax code, although thought by some to be outdated, continue to serve us remarkably well. At the same time, we stand ready to refine, clarify, and otherwise amend those points of contention that remain. And, of course, we will work with you and the members of your committee to accomplish these objectives.

I thank you.

[Mr. Scott's statement may be found in the appendix.]

Chairman LaFalce. Thank you very much, Mr. Scott.

Our next witness will be Mr. John Satagaj, the president of the Small Business Legislative Council.

TESTIMONY OF JOHN SATAGAJ, PRESIDENT, SMALL BUSINESS LEGISLATIVE COUNCIL

Mr. SATAGAJ. Thank you, Mr. Chairman.

First, I want to extend an apology on behalf of my chairman, Wayne Smith, who is also the president of the United Bus Owners of America, who was to testify today. He has a strong interest in this issue. However, he was called away on an urgent matter, and he did want me to express his appreciation to you for holding these hearings.

As you know, the Small Business Legislative Council is an independent permanent coalition of over 90 trade associations that have a common interest in small business. We represent the broad spectrum of small business, from agriculture through manufacture.

I would like to focus on a single issue today, and it is one single unfair advantage that non-profits enjoy over small business. It is an issue that I find the most troubling of all the issues, and it is perhaps troubling to me because the solution to it is less clear. When I think about competition, and the way small business competes, whether it is unfairly or fairly, the first thing that comes to mind is price, of course. We all try to make the price a little lower and we do that through cutting our costs. And my colleagues in the small business community who have testified before me have talked at great length about how you cut costs and how, perhaps, non-profits unfairly cut their costs.

The second factor we think about, when we talk about small business competition, is innovation. And I think we all know, particularly in this room, how well small business does with innovation. A better product, in better time, with better service, is what small business is all about.

After innovation and a better product, the next thing you think about is quality and service. And if the non-profit community was beating out small business on the basis of innovation, quality, or service, I don't think we would be here today, because we can live with those things as that is the way the small business community competes.

So it comes down to two things. The cost, which my colleagues talked about, and another unfair advantage that Mr. Hess mentioned briefly, and that is the "halo" effect. When we started to examine the problem of unfair competition, we began with the assumption that the non-profits gain market share by manipulating price through the cost advantages, since we did believe we do a very good job with innovation, quality, and service.

But as we began to uncover the stories of unfair competition, we found that the prices of non-profits were not significantly lower, but, in cases, were actually higher than the small businesses in the same community providing service. Why, then, did the market share of the non-profits increase? We could come to only one conclusion. The stamp of Government approval or even the term we were talking about earlier, the term "non-profit," provides the non-profit entity with an unfair advantage.

The plain fact is that some non-profits, and I want to stress "some non-profits," used this as an active marketing tool. Others simply have the advantage of it because they are non-profits.

Whether they are actively involved in the use of the "halo" or whether it is just because they are a non-profit, the names of non-profits appear on everything from tours to health newsletters. Whether it is in the belief that they are doing good, want to feel safer or otherwise protected, the plain fact of the matter is, consumers will buy from a non-profit even when the non-profit offers services at a higher price.

As I said, it is most troublesome to me because I don't have a solution for this problem. But it does certainly suggest that, at a minimum, we must be more careful in granting any Government recognition to an entity and that we ensure that the status, once it is granted, does not become solely an unfair advantage. I appreciate what this committee is doing in bringing the focus a little ways away from the unrelated business income, because it is a very complex problem. We have to look at each component of it, whether it is something like this "halo" effect, the postal subsidies, or the local and State property and State tax exemptions.

We appreciate the opportunity to appear here today and to, of course, answer any questions. We are looking forward to the discussion as you are, as well.

Thank you, Mr. Chairman.

[Mr. Smith's statement may be found in the appendix.]

Chairman LAFALCE. Thank you, Mr. Satagaj.

Our next and last witness will be Mr. Caspa Harris, executive vice president of the National Association of College and University Business Officers, on behalf of the American Council on Education. Mr. Harris.

TESTIMONY OF CASPA L. HARRIS, JR., EXECUTIVE VICE PRESIDENT, NATIONAL ASSOCIATION OF COLLEGE AND UNIVERSITY BUSINESS OFFICERS, ON BEHALF OF THE AMERICAN COUNCIL ON EDUCATION

Mr. HARRIS. Thank you, Mr. Chairman.

On behalf of the American Council on Education, a higher education association representing over 1,500 colleges and universities and 13 other higher education associations, I am pleased to provide testimony on the role and mission of higher education within the context of the issue of business competition.

Mr. Chairman, for 25 years I have served Howard University as its chief auditor, controller, vice president for Business and Fiscal Affairs, treasurer, and law professor. I am now the executive vice president of the National Association of College and University Business Officers [NACUBO]. It is my sincere hope that my perspective will shed some important light on this complex and sensitive subject.

In discussing the business competition issue, it is worth noting that we have worked closely with the House Ways and Means Oversight Subcommittee to identify ways of responding to concerns about competition through revisions of the unrelated business income tax. We are on record in support of many of its recommendations for changes in the unrelated business income tax, and we would like to emphasize that higher education is quite willing to be held accountable for both its tax-exempt and non-exempt activities.

We accept, for example, the Oversight Subcommittee's proposals to tax revenue from adjunct food sales, public patronage of hotels run by institutions, travel services not related to educational functions, and affinity card arrangements. We do not believe that computers should be sold to the general public and we do believe that reasonable limitations on sales of computers for students should be adopted.

We further support application of the unrelated business income tax to routine testing income so long as the statute provides a clear basis to distinguish testing from testing incident to research.

Some in the small business community seem to believe that higher education institutions intentionally undertake competitive practices that harm small businesses. I can tell you I know of no specific instances where colleges and universities have willfully undertaken income-generating activities in order to compete with a small business.

However, higher education is willing to acknowledge that there have been instances of excessive zeal in some revenue-generating programs conducted on some of our campuses.

We support the Ways and Means Oversight Subcommittee recommendations to increase disclosure and accountability requirements on the part of exempt organizations as a way to help prevent such overzealous behavior in the future.

We concur with Treasury's comments which urge that improvements be made in IRS forms 990 and 990T. I would also like to state that colleges are prepared to pay taxes on non-exempt activities as the law prescribes.

Mr. Chairman, we believe the answer to the concern about business competition between the for-profit and non-profit communities lies in promoting greater understanding, communication and collaboration between higher education and small business, particularly at the local level between individual institutions and their surrounding small business communities, and not in adopting overly-prescriptive new Federal and State legislation.

We support Treasury's comments that increased cooperation between the two communities would be mutually beneficial. There are sound reasons for both higher education and small business to recognize each other's legitimate concerns and to work together to resolve these concerns on a case-by-case basis.

We believe this would be a positive development and it is one of the reasons that the NACUBO developed and published business competition guidelines for colleges and universities last year. We will provide copies of these guidelines for your information.

Higher education satisfies these exempt purposes through the pursuit of three traditional functions, instruction, research, and public service. Instruction is the core of higher education. This function cannot have or be carried out in a vacuum. Colleges and universities have traditionally provided support services such as dormitories, cafeterias, bookstores, health care services, and parking garages for their students, faculty, and staff. It is important to note that these services are provided by colleges and universities on a long-term basis, regardless of current market and economic conditions.

Our Nation's institutions of higher learning conduct research which results in the creation and advancement of new knowledge. Both the Federal Government and private sector have long recognized and supported higher education's role in developing new technologies in important areas of national concern.

Technological transfers to the private sector have led to many successful business-university partnerships. And the development of research products later advanced successfully through the private sector.

The third mission of higher education is its commitment to public service. Consistent with a long tradition, colleges and universities provide such diverse services as continuing and adult education programs, technical assistance to various segments of the community, and cultural events. Colleges and universities are also host to a growing number of small business development programs, such as centers sponsored by the Small Business Administration, State supported agriculture and economic assistance programs that provide an important source of direct aid to help maintain a strong economic climate for business development and technical assistance programs that offer advice to companies that cannot afford inhouse expertise.

In all three functions of instruction, research, and public service, higher education has set out to meet the demands placed upon it by our society to provide the best educational system in the world. The United States is one of the few countries in the world that depends significantly on non-government resources to provide the country's higher education system. Its national policy is affirmed by Federal and State tax exemption legislation. There is great diversity within higher education today, making it difficult to offer a single prescription for accommodating small business concerns about competition.

Higher education is composed of public and private institutions, small and large, 2-year and 4-year institutions, located in urban and rural settings. Each determines its own unique educational objectives and responds to the needs of its varied student population and community. We recognize that the small business community can and does provide important services to campuses and students. However, we also feel strongly that individual institutions must maintain the right to make decisions on whether or not to utilize the particular business resource, based on their own best judgment. We feel this process is no different from that used by any other business which must make sound, cost-effective, and efficient decisions.

I would like to suggest several actions that I believe may facilitate improved communications.

First, leaders within the higher education and small business communities must make a commitment to encourage greater communication and to create a structure to facilitate problem-solving between those specific institutions and business owners experiencing difficulties at the local community level. Although this may sound self-evident, we feel this is an essential step toward resolving a great many of the business competition problems that exist today.

In addition, it is the shared responsibility of business and education leaders to make their constituencies acutely aware of the sensitivities existing within both communities. NACUBO has held and will continue to hold national workshops and seminars on complying with the existing unrelated-business income tax laws and working with the small business community.

These kinds of professional development activities need to be provided by both communities, as well as those sponsored through the Small Business Administration.

Finally, national business and education associations should meet on a regular basis to hear concerns and to respond to them accordingly. For example, NACUBO has met in the past with the Business Coalition for Fair Competition and plans to continue this effort in the future.

Mr. Chairman, I would like to thank you and the committee for providing me this opportunity to express the views of the higher education community here today. I ask that my full statement be entered into the record, and I would be happy to respond to any questions that you or any of the members may have.

Thank you.

[Mr. Harris' statement may be found in the appendix.]

Chairman LAFALCE. Well, thank you very much, Mr. Harris. I think that was an excellent statement. It was very balanced and I especially appreciate the suggestions you made at the conclusion of your remarks. I think they are excellent ideas, and basically you are saying, "Let's get together. I think we have common interests and we both have problems. We have to understand each other's perspective, and let's work on it together." I think that is exactly what is needed. I am going to call on the other members for questions, and I have a number of questions. But before I do, I am just going to make a couple of observations. I will be thinking aloud more than anything else, so you can get an idea of where I am coming from.

It seems to me that you have a problem here that is serious and growing. And in all probability, we are not going to be able to address it in a meaningful way in this Congress. We are at the 4th of July recess, the Democratic Convention, back for a week in August, the Republican Convention, back at Labor Day, and we look forward to adjournment.

So I do not expect that we are going to come to grips with any aspect of this problem in this Congress, whether it is the recommendations from Ways and Means, or anything else. So we are probably looking forward to the next Congress.

Yesterday's hearing and today's hearing at least brought me to the point where I think that this should be a priority issue for the attention of the Small Business Committee in the next Congress in a holistic sense. There are many aspects to it.

So if I am reelected to Congress and as chairman, I think that you can count on that. My perspective is that small is beautiful, but that Catholic Charities is beautiful, and that health organizations, and educational organizations are beautiful, too. And what do we do about reconciling all of these difficulties? I do not know, but we ought to start talking together.

I personally intend, and I am thinking right now that I should form some type of a group that I can work with, maybe the members at this table and maybe some others, to try to come up with some ideas to address this issue in a balanced and reasonable way. Also in the back of my mind, I am thinking, I am on the Banking Committee, and right now one of the things that we are talking about is giving certain powers to banks that they have not had historically, at least within the United States.

One of the things that we are talking about doing, if we are going to do this, is establishing what we are calling fire walls. We are talking about requiring banks to establish separate subsidiaries for these separate types of activities. And some of these fire walls could deal with some of the "halo" effect that banks have also.

In the back of my mind, I am wondering about the approach that we are thinking of with respect to financial institutions getting into the securities area, and saying that this type of activity you have to do separately. If you want to underwrite mutual funds, because a bank has the full faith and credit of the Federal Government and there is a "halo" effect, and you have an unfair competitive advantage in underwriting mutual funds, if you were able to call yourself the Chase Manhattan Mutual Fund, for example, you have got to use a different name. Maybe there are some analogies here that might be applicable to non-profits.

I do not know, I do not know. These are some of my thoughts. Also, a thought that I have is that while nothing is more important in my mind than education and health and charitable activities that I find myself rebelling against the argument that the administration and the Congress have put it to us here, and put it to us there, and put it to us in other areas, and therefore we need something to compensate for the unfair treatment that the administration and the Congress have given us, and therefore do not touch this benefit that we receive.

Somehow that strikes me as two wrongs not making a right. And the argument that you should not make a change in a practice because other changes have been made over the past five years or so which have been to the detriment of education, or health, or welfare, or other non-profit organizations, that just does not go over very well with me personally. It seems to me that we have to attack the problem elsewhere to deal with the changes that have been made.

Those are some of my thoughts to give you an idea of where I am coming from. Now I will turn to the other members for questions. Mr. McDade.

Mr. McDade. John, thank you. And I first want to express my appreciation to the members of the panel for being here, and compliment all of you. There were two things that occurred to me as I listened to you and your testimony. And the first thing was that if I were having a meeting back in my District involving one of my hospitals, or one of my universities, or something that was going on in the community, I would want all of you to be sitting at the same table that you are sitting at today. You are the kind of people that I would be seeking out to try to work the problem.

The second thought that I had as I listened to you, and particularly, Mr. Harris, as you concluded, that if we were to lock the door in the room and say that we are going to spend the day here on the problem, we might walk out of here with an agreement of the people at this table as to how to deal with the problem.

Every one of you, I think, presented a very cogent argument for your position. I did not hear a great deal that to me indicated that there would have to be a tinkering with the code. We fiddle around with definitions, and we try to do things here and there that have impacts, and they are so significant. But what came across to me was here are the people raising the revenues and paying the taxes, and here are the people providing the services that so many of our people rely upon.

And I really did have the impression that maybe you do not need governmental action. Maybe what you need is some kind of an agreement among all of you that would be a self-mechanism to try to deal with the problem, all of them real problems, price advantages, and so forth. You mentioned egregious comments here and there that have come up.

But I wonder, does everybody at the table feel that this needs Government action to solve the problem?

Mr. SATAGAJ. Mr. McDade, I will take the first shot from the small business community. It is always terrible to disagree with a Member of Congress, but I will. We have had many cordial discussions among the people at this table. We have talked quite a bit. Joe O'Neil, who runs the Business Coalition, can document at great length the meetings that we have had.

Mr. MCDADE. The group at this table?

Mr. SATAGAJ. Yes.

Mr. MCDADE. Essentially?

Mr. SATAGAJ. Yes. A number of the people at this table with the Business Coalition. Our umbrella group in the business group has met quite a few times with people around this table and elsewhere.

Mr. MCDADE. About how many meetings have you had?

Mr. SATAGAJ. Pardon?

Mr. MCDADE. About how many meetings?

Mr. SATAGAJ. Mr. O'Neil, you would have to address that over years. How many?

Mr. O'NEIL. We just set up another one this year for September. We believe in the value of the meetings. I do not think that it is an either/or solution. I think that the meetings are necessary. I think that we have mutual respect for each other and our points of view. We see the difficulty of reconciling two goods, public service and small business' health and welfare. And we want to meet to try to continue to better understand each other.

But we do not feel that meetings alone will solve the problem. There needs to be action taken, because there is a set of Government-granted benefits that constitutes the inequity, and nobody but the Government can do something to remove the inequity.

Mr. MCDADE. We start with the fact that there is a conferring of the status and a tax exemption, and everything flows from that. But let me ask you this question. It was suggested that there might be fewer people violating what might be called a norm than it appears to be. It is suggested that maybe an ad hoc kind of an approach, a case by case. For example, the university and the private enterprise was mentioned. I do not know if you would all agree that that was conduct that ought to be changed or not.

How many of you would agree that that is the kind of conduct that ought to be changed?

Mr. SATAGAJ. Four to four.

Mr. McDADE. There is not as much commonality I suppose as I guess that there ought to be. Let me ask the question this way.

Or Ms. Johnson, did you have a comment?

Ms. JOHNSON. Yes. I would like to respond to your suggestion. Because we certainly believe, and I mentioned in the testimony, that many of these conflicts if we do come together at the local level, we can work them through. Because with most of the service agencies, the decisionmakers are small businessmen, because they are on our boards. So they are already involved with small businesses.

We have already begun to have a number of meetings across the country. We have had them in Baltimore, MD, San Francisco, CA, and Harrisburg, PA, bringing together small business and human service organizations to look at it.

Chairman LAFALCE. What we may need are some hearings across the country in addition to these meetings, so that these meetings could be public in nature.

Ms. JOHNSON. One other point that I wanted to make, too, as it relates. You keep mentioning the "halo" effect. There is one basic difference with human service organizations and small businesses that provide services. Human service organizations by their very mission must be concerned with people who cannot afford the services. And these are people who are not served by small businesses, because of the profit motive.

I was in St. Louis visiting one of our agencies yesterday. And 57 percent of the people served by that organization have incomes below $15,000 with the majority of them being below $10,000. They could not serve those individuals without contributions from the United Way, without contributions from other sources, and without charging fees for service to subsidize those people.

So whatever changes you make, please remember that human service organizations and hospitals also have the responsibility to serve those who cannot afford to pay. And the benefits that we get from various Federal legislation such as not paying taxes on property and sales tax, that enables us to serve this large number of people in our society who would not get services.

Mr. McDADE. I would hope that none of us are approaching the problem from the standpoint of changing that magnificent service that is provided.

Ms. JOHNSON. But I am making the point that we can only provide those services, because we are able to charge fees for services.

Mr. McDADE. And as I say, it does not appear to me that that is the kind of activity that anybody is finding controversial. In fact, to the contrary, we compliment you for the work that you do.

Mr. O'NEIL. Let me just comment on that. Not to dispute the individual case that has just been cited, but there are reports that would contradict the kinds of things that Professor Harris had cited. In some cases, it is at least true that there is not a distinction between the amount of service given to the needy by the non-profit in comparison with the counterpart for-profit.

In Utah, for instance, a hospital was denied its tax exemption from property taxes by an assessor on that very basis, that they were not doing a distinctive amount of service to the needy. And I have seen reports of national statistics that indicate little difference in the amount of charitable service provided by non-profit and for-profit hospitals.

So again, I am not the expert, but these are things that have been published. And I know in the Utah case that the hospital which lost the exemption took it all the way to the State supreme court and lost on that very basis.

So that is our point. That where the needy are being served, fine, let the exemption stay. But where the needy are not being served in a distinctively different style from for-profit service, why should the Government subsidize.

Mr. McDade. Mr. Hess.

Mr. Hess. Apparently, Mr. O'Neil and I have the same source of information. Because I was going to report to you a study that has been published just recently in respect to the health care that showed no real differentiation between the needy being served by for-profit versus non-profits. I can try to get a copy of that and see that it becomes a part of the record.

Mr. McDade. John.

Mr. Motley. I just wanted to answer your original question. And that is that we do I think see the need here for a clarification of a substantially-related test, and we view that as being the whole problem. Just an example, and it may be a sensitive one to pick out, but you have the IRS revoking the PTL's non-profit status recently. A lot of the activities that it was involved in would not have been allowed if there was some sort of a prequalification or a pre-clarification of the fact that those activities were not substantially related to the activity of PTL.

So I do think that there is a need for clarification. And if we clarify, then we can eliminate an awful lot of the discussion and the confusion.

Mr. McDade. Mr. Hess, are you saying that there are only a few egregious offenders?

Mr. Hess. Of all of the non-profit organizations as I know them, I think that the percentage of the egregious offenders is very small.

Mr. McDade. Would everybody agree with that?

Mr. O'Neil. I might make a comment.

Chairman LaFalce. We do not want to throw out the baby with the bath water.

Mr. O'Neil. No, no. I realize that. I would personally question how one qualifies "a few."

Mr. McDade. It seems to be increasing though. I mean if you are going to have a meeting, maybe you could have an earlier one in September, and sit down and see if you could submit to us, to the committee, a joint statement of some examples that you agree upon. And then if you want to do as we do around here, a dissenting opinion, perhaps a dissenting opinion to say that we disagree on this, it would be very helpful to focus the issue for all of us.

I know that is a hard task for all of you. But you have the meeting and are talking. And that would be a help to sharpening what may be some kind of a solution to the problem.

Chairman LAFALCE. In my experience, whenever you have two groups, one really seeking change and one sort of wishing that there would not be this climate for change, you see a certain aggressiveness on the part of one side and a certain inertia on the part of the other, that is why you need a catalyst. I think that I understand this tendency in human nature, and therefore, I think that this Small Business Committee should attempt to be the catalyst.

Mr. MCDADE. Why do you not try to provide us a statement in 30 days, let us say, of what you would agree would be egregious and non-egregious.

Would that be too difficult?

Mr. AHMANN. Mr. McDade, I wish we could do that. But one of the difficulties is that we all use examples when we do not really know the facts. Take PTL's status change by the IRS. Well, the question of AARP and National Geographic relates to that. I would like to ask anybody in this room if they know whether AARP or National Geographic are paying any taxes. They do not know. And it is very difficult to take what is an apparent egregious abuse and get the facts on it.

I think that therefore committee action or congressional action is important. And I think that the Ways and Means action was important to at least start to pin down some abuses to strengthen the law.

Chairman LAFALCE. Would it be egregious if in fact they were not paying taxes?

Mr. AHMANN. You have to look at it case by case. It seems to me that you could make one case about their basic membership, and a different case about the tour business, or a different case about the automobile business, and so on.

Mr. MCDADE. Mr. Scott wanted to be heard, and I did not give him a chance.

Mr. SCOTT. Yes, Mr. McDade, I wanted to make a point. A couple of people referred to the differences between for-profit and not-for-profit hospitals in providing charity care. I do want to make a few comments. One, there are a variety of studies on this point. The most recent one which was published in the New England Journal of Medicine showed that there was a significant difference. It varied State by State, primarily depending upon the quality of the Medicaid plans. But in some States, non-profit hospitals gave almost 50 percent higher amounts of charity care in this most recent study. I will admit, though, that there is a difference here with other studies, and somebody should carefully research those findings.

The one thing to keep in mind on the charity care issue is that charity care is primarily a function of the site of the hospital. If you build a hospital in a poor community, you can expect to have lots of charity care. If you build a hospital in a well-to-do suburb, be that Northern Virginia or any other affluent area, you do not have as much.

I think that if you take a look at the inner-city areas, at the poorer neighborhoods in our communities, you find that the hospitals located in those areas remain public and not-for-profit.

Second, I also wanted to make a point, and I am certainly not at all criticizing the for-profit aspect of the health care industry (I should note that that is not exactly a small business), but there is an awful lot of difference in the range of community service that is provided. Again it is the not-for-profit hospital that has the neonatal intensive care units, and the burn units, and some of the expensive things that are required for health needs but will never, never make a dime in profit.

Mr. McDade. And are they placed there through the planning processes among the local hospital groups? That is what I hear back home, but I am not sure that is true.

Mr. Scott. Some of this has been an outgrowth of the planning process. Organized planning in our country, of course, for health care was a relatively recent phenomenon in 1974. Many of these kinds of activities are part of the heritage.

Mr. McDade. My time is much expired. I want to thank all of you for your attendance.

Chairman LaFalce. Mr. Mfume.

Mr. Mfume. Thank you very much, Mr. Chairman. And I would also like to thank the panel of witnesses for their testimony this morning. I think that it has been well presented, and apparently very well thought out. And as was the case yesterday with the people who were before us in their testimony, it is extremely useful in assisting the members of this committee in our efforts to really obtain an intellectual as well as a practical understanding of both sides of this argument.

I said yesterday to the chairman, and I think that it is worth repeating, that this is a fascinating domestic issue, a fascinating issue on public policy, and one of the more interesting issues that has come before this committee since I have served on it.

And I find it interesting for a number of different reasons, probably because I think that I understand a little bit of both sides, which does not help me in trying to resolve this. But it keeps certainly my interest and the interest of many members of this committee very much alive. And I agree with the chairman that it will probably be in the next session of Congress in which we are able to move in any sort of direction of finding a consensus.

Mr. Harris, let me say that I particularly appreciate the thrust of your testimony. And speaking on behalf of your organization, that they are prepared at this point to admit freely that they are going to go along with the concessions that come out of the Oversight Subcommittee's recommendations. The suggestion for regular meetings and regular dialogues, now even that I hear it has been occurring, I think is still a very valid suggestion.

I would like to associate myself with the chairman's remarks, suggesting also that maybe there ought to be national hearings through this committee across the Nation, and this is something that we ought to take under consideration.

Mr. Hess, let me say that I was pleased to hear your desires to root out those deliberate and flagrant abusers who have an exemption, and are trying at the same time to leave intact those entities who are not abusing it and tend to represent by and large the overwhelming majority.

My ongoing fear, and I expressed it yesterday, is that I think that if we move with too broad an approach and paint with too broad a brush to try to correct the problems that have been articulated that we may in the process provide a disincentive for those very real and very much needed charities and non-profits that serve us in this Nation.

And my greater concern was trying to find a way to reach a specific set of recommendations that would deal with specific problems. And I just want to repeat that again.

Mr. Chairman, I really do not have questions today as much as sort of a rambling ongoing commentary on the last two days of hearings. And I am sorry that the gentleman from Virginia could not be with us throughout the duration of the hearing. But he said something yesterday that I thought was fascinating; that maybe we should look at simplification as a means of correcting the problems that exist by establishing permissible activities, and establishing very real parameters that both sides can agree on. And that maybe the idea of simplification is something that ought to be offered up for consideration as well.

Having said all of that, I welcome the opportunity to continue to explore the issue and to hear both sides of the argument, as I am sure they will continue on. I personally and publicly want to thank the chairman for holding these hearings. I think that they are very, very important on what I consider to be a very important public policy issue. Thank you, sir.

Chairman LaFalce. Thank you very much, Mr. Mfume.

Mr. Hefley.

Mr. Hefley. Thank you, Mr. Chairman. I, too, think that these are very important hearings. It is a difficult situation. With our strong commitment on this committee to small business and furthering the needs of the small business, and yet our desire not to do something that would be damaging to what really is a unique system of volunteerism in America.

I do not think that any other country in the world experiences it to the extent that we do. I had a friend who was invited to go to Nuremberg after the Second World War, who was for many, many years the executive director of the United Way in Baton Rouge. He was invited to go over there and try to teach the Germans how to set up a voluntary system over there of giving services.

He came back after several months after having thrown up his hands in despair, and said they just do not understand that. They will never have a voluntary thing over there. They do not understand this voluntary system that we have.

So we do have three sectors. You know very well my long-term commitment to the third sector. But at the same time that I say that, I am still besieged by constituents who complain because Goodwill has opened an upholstery shop in competition with the small upholsterers in the community, a shop not designed to train handicapped people to upholster, but a shop which actually competes for experienced upholsterers to come in and do the job in order to make money for Goodwill, so that they can use that money then to service handicapped people.

The laboratories, the university laboratories, there are constant complaints about the university laboratories, and what they are doing to the private laboratory system. We get that all of the time.

Chairman **LaFalce**. And that is different than the voluntary organizations.

Mr. **Hefley**. Well, yes.

Mr. **Hess**. It is painted with the same brush.

Chairman **LaFalce**. It is painted with the same brush, but I do not know that the "halo" is as deserved there as it is elsewhere.

Mr. **Hess**. Oh, the "halo" is there. The pitch is that you can give contributions to your alma mater and get your services, and get double bangs for your bucks, and all of the credibility and everything that goes with it.

Mr. **Hefley**. I am not sure that there is a great deal of difference there. Because the university does receive tax dollars and volunteer dollars as well, as does many of the social services, the family service agencies, and so forth. So I am not sure.

One of the things that I have been encouraged by the whole panel is that everybody seems to recognize that there is a problem. We may recognize it in different degrees, but we seem to recognize that there is a problem.

You touched a little bit on some of the steps in terms of the meetings at the local level and so forth, but what are the steps that are being taken by human service agencies to reduce this conflict, what steps are being taken?

Ms. **Johnson**. We are also utilizing through the independent sector, the United Way and the National Assembly, and preparing all kinds of educational materials for our organizations to make sure that they are related to the kinds of things that relate to their mission, and where they are actually involved in activities that might be considered unrelated business income tax that they paid the taxes. So we are educating our organizations to look at the issue, and to be fair as far as areas that they need to be paying taxes in.

Mr. **Hess**. Could I ask a question?

Chairman **LaFalce**. Yes.

Mr. **Hess**. I would like to ask the volunteer agencies if this was going on before the 1986 White House Conference. I have spent years trying to get their attention and have usually been turned away. Now that there is a threat, there is a response, and I am glad for that response. But I am saying that you have to keep the pressure on. Otherwise, the status quo will persist.

Chairman **LaFalce**. Mr. Hefley.

Mr. **Hefley**. Mr. Chairman, are you ready to go vote, or do you want to wind this up before this vote?

Chairman **LaFalce**. I think that we are going to have to wind this up.

Mr. **Hefley**. Let me touch on something with John for just a minute, if I might.

John, on the tax exemption thing that you touched on, where is the real problem there, is it mostly at the State or local level, the property tax forgiveness and things like that, or is it the Federal tax?

Mr. MOTLEY. Well, I think that the initial decision for a Federal tax exemption, as Mr. McDade said before, is really the key. Because from that tax exemption, almost everything else flows. And in order to go back and to stop it, you have to go back and investigate on a local level and everything else.

You have cases in Tennessee, and in Oregon, and in Utah which have mentioned where local tax assessors have revoked the tax-exempt status of the institution. But that institution has operated as tax exempt with all of the benefits flowing from it up until that investigation.

It would seem that we could head off some of these problems if we could make some sort of determination early on whether that activity should be tax exempt or not. So I would say that it is the initial decision, and it is probably the best place to catch it.

Mr. HARRIS. Mr. Hefley, if I may, on that point. I am not sure that I totally agree that the tax exemption is the problem. If all of the Nation's 3,000 colleges and universities were to forego their tax exemptions, I doubt if 10 of them would pay taxes. Because if you take the total costs of running an educational institution today, I know of not one that is really making a profit.

As Congressman Williams said when he testified this morning, the Nation's colleges and universities are in very serious financial difficulty. One of the reasons that they are into some of these business activities, quite frankly, is that they are seeking other sources of revenue just to operate today.

Back in the days of the 1950's and the 1960's, colleges were not subject to court decisions. And I am not arguing that this is or is not good. We have to be accountable for all of the things that happen on our campuses. We also have to pay enormous insurance premiums which have been extremely high. As well as increased costs for fuel oil, salary increases for our employees, increased cost for material, and so forth. We have all of the costs that every business sector, large and small, has had plus some additional costs many do not have.

The big problem that we have here quite frankly is one that we need to work out with the small business community. I do not doubt that at all. We need to sit down, and we need to work out some mechanism to satisfy both entities.

Quite frankly, if higher education were frozen out of many of these activities, that basically means that the costs to our students are just going to increase more and more. We are trying to keep these costs as low as possible. We are not in any business activity deliberately trying to freeze out small business that I am aware of.

Chairman LAFALCE. Excuse me, Mr. Harris. I hate to interrupt you.

Mr. Dreier, do you have any questions that you want to get into?

Mr. DREIER. Thank you very much, Mr. Chairman. I am sorry that I was late. I was in a meeting on the banking bill, and that prevented me from being here. I know that we are trying to hurry. And there are so many witnesses here, that I suspect that the answer to my question may have to come in writing.

Of course, like everyone on this committee, I am very sympathetic to the deleterious impact that this is having on the small business sector of our economy. But I would like to ask members of the panel if some of the incentive for non-profits to move into these other areas has been in part due to other Federal constraints which have been imposed on their particular area which have forced them into this position. And maybe that was covered in some of the testimony before I got here, but I would just be curious to know if there are any examples.

I am, of course, aware of the expense imposed on the medical industry, hospitals of course. We are all aware of that. But if over and above that there are areas in particular where we at the Federal level have created a climate which has forced them to do this.

Mr. MOTLEY. The climate has forced non-profits to expand their use of fees for service, which is something that historically it has always done. It is not a new activity and it has not been considered a taxable activity. There is little evidence, very little evidence, to indicate that non-profits by and large have gone into new straight out commercial services.

There is I think one small consulting firm in this country which has come in being to advise non-profits going in that direction, and there are some that are considering and some that have done it, but there have been no substantial new ones. It is fair to say though that there is talk about that, and that is because of the squeeze that they felt on the budget.

Mr. O'NEIL. I disagree with a lot of that. One example of lack of constraint is in the educational area. I am told that during the Reagan administration appropriations for higher education have increased from $10 billion to $21 billion. This contradicts the thought that less money for education is forcing them to do commercial work.

Mr. DREIER. I am not talking about direct dollars. I am talking about regulatory constraints that may have created a difficult situation.

Mr. O'NEIL. I also dispute the contention that there is not a lot of new commercial activity being started by non-profits. We see great evidence of that.

Chairman LAFALCE. Thank you. Unfortunately, we do have to go vote.

Mr. DREIER. I would like to have them submit for the record a response to that.

Chairman LAFALCE. Surely. Please do so. I think that this has been an excellent panel. We have a diversity of perspective here. There is no question about it. The only thing that I can assure you is that we have touched this issue, and we are now not going to let go of it. So work with us, because we are going to be delving into the issue.

I think that the first thing that I am going to want to do is try to define the scope of the problem. And therefore, we might come out with a questionnaire. This is what I have in mind right now, a letter with a series of detailed questions trying to focus in on the extent of the problem. And then once we can focus in on the nature of the problem, maybe then we can pool our heads to try to come up with some balanced way of dealing with it. I thank you very much. You will be hearing from us.

The Small Business Committee is adjourned.

[Whereupon, at 11:51 a.m., the committee was adjourned, subject to the call of the Chair.]

APPENDIX

EXECUTIVE OFFICE OF THE PRESIDENT
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PREPARED STATEMENT
of
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before the
COMMITTEE ON SMALL BUSINESS
U.S. HOUSE OF REPRESENTATIVES
WASHINGTON, D.C.
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Mr. Chairman and Members of the Committee, it is a pleasure to discuss with you the evolution and implementation of OMB Circular No. A-76, "Performance of Commercial Activities."

Evolution and Description of the Program

Both the Executive and Legislative Branches of the Federal Government have long been concerned with the extent of Government competition with private enterprise. As far back as 1932 a Special Committee of the House of Representatives issued a report which expressed concern over the extent to which the government engaged in activities which private enterprise might perform more appropriately. The first and second Hoover Commissions, established to study Executive Branch organization, expressed similar concern in the 1940's and recommended legislation to prohibit government competition with private enterprise. However, there was no formal policy until 1955, and then only after the Chairman of the Senate Governmental Affairs Committee, Senator McClellan, introduced S. 1003 with the statement:

> "It is timely that the Congress go on record in favor of a definite policy on non-competition with private industry in the production of goods and the securing of necessary services."

Final action was dropped upon assurance from the Executive Branch that the policy was being implemented administratively.

The Bureau of the Budget issued Bulletin 55-4 on January 15, 1955. That document announced a general policy that the...

> "Federal Government will not start or carry on any commercial activity to provide a service or product for

> its own use if such product or service can be procured from private enterprise through ordinary business channels."

Exceptions were permitted only when it was clearly demonstrated in specific cases that the use of the private sector would not be in the public interest.

Since 1955 every Administration has endorsed publicly the general policy of reliance on the private sector, but each has modified the procedures slightly to require more cost competition between government operations and private industry to recognize the responsibility to the American taxpayer to make the most efficient possible use of tax dollars.

There have been six major revisions to the original 1955 policy. The most current circular, which the Reagan Administration issued in August of 1983, retains the general policy that the Government should rely on commercial sources to supply the products and services the Government needs. This general policy is implemented in two ways:

> (1) New requirements that can be met by commercial sources are to be obtained through competitive contracts.
>
> (2) Government-operated commercial activities are to undergo a competition with non-federal sources to determine who shall do the work.

The first policy has been implemented by the agencies fairly consistently over the years. In 1987 the agencies purchased services which would be covered by A-76 cost comparisons if performed by Government personnel in the amount of $53.4 billion. Attachment 1 shows the dollar amounts of the contracts by type of work.

The second policy, competing government-operated commercial activities with outside sources, has proven to be more difficult to implement. Over the years, agencies occasionally used this part of the Circular when faced with personnel or dollar reductions, but the Executive Branch did not drive a centrally managed program. A "make or buy" program is never popular with the managers and employees affected, whether in private industry or the government. It can mean a loss of jobs or at the very least a change in the way business is done, and change is always resisted. However, in the mid-seventies, the Department of Defense, faced with resource shortages had begun to experiment with the competition concept in a formal manner, and achieved significant savings. At that time the potential savings that could be obtained through the A-76 program was recognized as was the fact that government employees and managers would not willingly participate in the program unless they perceived that they had at least a fair chance of winning the competition and retaining their jobs within the Government. Improved productivity through competition, in effect, became the new policy in the Circular issued in 1979.

Between 1979 and 1983, when this Administration issued a revised Circular, Defense studied an average of 5,700 jobs per year under this new concept and generated annual cost reductions of over $350 million. However, the civilian agencies continued to resist the program. The new circular of August, 1983, strongly emphasized the competition concept and made it mandatory that a senior government official certify that the government operation was made as competitive as possible before comparing its costs with the private sector. Much more central management attention was focused on the program.

Results of the Program to Date

The results of the program since 1981 are:

- Approximately 72,000 positions studied; an average of over 10,000 jobs per year;
- Approximately some $696 million in annual cost reductions -- over $9,600 per position studied;
- Cumulative cost reductions of $2.85 billion; and
- Some 45,697 positions saved or shifted to other priority needs.

The private sector has won about 60 percent of the studies with an average taxpayer savings of 35 percent. The Government entity has won the other 40 percent of the studies, with average taxpayer savings between 17 and 20 percent.

The circular requires that preferential procurement programs for small and disadvantaged business must be considered, as required by applicable procurement regulations, whenever a cost comparison is accomplished. The Small Business Administration currently is conducting a study of the participation rate, across the Government, of small business in the A-76 program. In fact, the average size of an A-76 study is less than 20 positions, and most A-76 competitions are set aside for small business. The Defense Department, which has accomplished over 80 percent of the studies, reported its small business participation rates to Congress on two occasions: once in 1984, covering 235 contracts awarded between October 1980 and October 1982; and again in 1986, covering 131 contracts awarded from October 1983 to October 1984. Small business received 79 percent of the contracts and 62 percent of the dollars in the first case and 82 percent of the awards and 74 percent of the dollars in the second case.

While the results since 1981 have been impressive, the number of positions reviewed represents less than 10 percent of the number of positions that we estimate could be competed. At the end of 1986 the agencies had identified over 16,000 commercial activities containing some 323,000 positions. However, we estimated that over 757,000 positions remain to be competed. This estimate meant that the Federal Government was still one of the largest commercial enterprises in the world, spending at least $20 billion annually for civil servants to provide commercial-type services. Based on past experience, if all of these positions were studied competition could transfer to the private sector approximately 375,000 jobs, at taxpayer savings of some $7 billion annually. The Congressional Budget Office (CBO) in its report of June 1987 on Circular No. A-76 stated that there are 1.4 million federal workers in occupations likely to be engaged in providing commercial services. The CBO number would mean that the cost of Government provided commercial services is close to $40 billion annually.

Current Status of the Program

While this Administration has almost doubled the number of jobs being competed, at the current levels of studies it would take 75 years to offer business the opportunity to compete for all the work and the very success of the program in challenging the status quo has continued to generate strong resistance.

Because there have been no significant penalties for failing to achieve program goals nor rewards for timely completion, the study process tends to drag on for extended periods, to the detriment of the employees, prospective contractors, and, of course, taxpayers.

In addition, Congress, in reacting to Federal employee concerns, has enacted 37 legislative impediments to privatization in general, and the A-76 program in particular. For example:

- The Federal Aviation Administration is prohibited from conducting even a pilot test of contract maintenance for national airways system facilities; and

- The Department of Defense is prohibited from studying core logistics maintenance functions.

Six more restrictions are now being considered by this Congress. Attachment 2 contains a listing of these impediments and restrictions.

In light of the dramatic potential for cost reductions and increased private sector participation in providing government services, we recognized a need to revamp the program again to gain acceptance of all the various interest groups. In November 1987, the President set the future direction of this program by issuing Executive Order 12615, "Performance of Commercial Activities." (See attachment 3.)

One of the key tasks required by the Executive Order is for each agency to identify all of its commercial activities, including those exempted from competition by Congress or the agency itself. These inventories were due on April 29, 1988. Only 11 agencies have submitted inventories so far. However, 844,000 jobs have been identified. Many of these are shown as exempt from competition for a variety of reasons, and we are analyzing inventories and the exemptions and holding discussions with the agencies, as needed. Meeting the President's direction to define this universe is a difficult task and, quite frankly, I believe it will be early fall before we will be able to achieve agreement on the full inventory.

The Executive Order then requires that we publish this inventory for public review. At that point, all interested parties will know what specific activities will be studied and in what year. They will also know what activities have been exempted from competition and why. This will be the first time the potential of the program will be truly defined. We certainly will share the information with this Committee so that a full analysis of the areas available for small business can be made.

The Executive Order requires a five fold increase in the number of studies accomplished each year. Beginning in 1989 it establishes annual study goals at the rate of 3 percent of each agency's civilian population until the inventory has been completely studied. This equates to an opportunity for business to compete for over 57,000 jobs in 1989 and each year thereafter.

This is a dramatic, but necessary, acceleration in the program. However, we recognize that for the program to be successful the agencies and the workforce need to be able to share in the program's benefits. Therefore, the Executive Order requires the agencies to develop and maintain effective job placement programs and to cooperate fully in interagency placement efforts. The Office of Personnel Management is charged with revising, as necessary, personnel policies and regulations to reduce adverse effects of productivity improvements on employees and to give federal managers the flexibility to be competitive with the private sector.

The Executive Order also provides for sharing the potential savings among the employees, the agencies, and taxpayers as a means of stimulating the program. Specifically, it allows us to set up an incentive program modeled after those in the private sector.

We anticipated savings from A-76 studies in each agency's budget in FY 1989. Savings in the budget totaled $238 million and 23,000 employee positions. We did allow agencies to retain a portion of projected savings to reward those employees covered by the studies for their efforts in reducing costs. We will closely monitor the results of this cost-sharing approach.

Other management improvements in the Executive Order include the appointment of a senior-level official in each agency to manage the A-76 program and other privatization efforts and the establishment in OMB of a tracking system to monitor the progress and results of each study on a quarterly basis. This system will require the reporting of small business data. This will give us the ability to monitor the small business participation by type of function as well as on an overall basis, which we cannot do now.

We believe that this kind of management attention to the program will increase the opportunities for small and other types of business to provide Government services. It is already having a significant impact. We expect about 20,000 jobs to be competed in FY 1988. This is a 75 percent increase over the 12,000 jobs competed in 1987. The Corps of Engineers is a good example of a program that is being managed properly. The Corps has done a tremendous job in instituting the President's policy this year, and will compete 550 jobs in 1988, compared to only 65 jobs in 1987.

To reach the programs potential we need your support. The current legislative restrictions will prevent the competition of hundreds of thousands of commercial jobs. One example will illustrate this point. The Veterans Administration is required to maintain government employment levels in the Department of Medicine and Surgery at 194,140 full time equivalent employees. This means that 12,145 food service jobs, 6,430 pharmacy jobs, and 11,119 custodial jobs are not available for competition with private industry. These jobs lend themselves to small business participation. We will have a complete accounting of the restricted jobs when the inventory is complete.

To summarize, Mr. Chairman, the current A-76 policy requires new commercial requirements to be provided by the private sector and the President has taken the lead in stimulating increased private sector opportunities to provide services now performed by the Government. The potential for increasing the development of small business is tremendous. I will be happy to work with you to achieve this goal.

. . . .

Mr. Chairman and Members of the Subcommittee, that completes my prepared statement. Now, I shall be happy to address any questions you might have.

The following information is from GAO Report GGD-88-63 FS, "DOD Functions With Savings From Private Sector Cost Comparisons," dated April 1988.

Table II.1: DOD Functions and Estimated Savings from Past A-76 Cost Comparison Studies Ranked from Highest to Lowest According to Estimated Savings Rate

Function	Number of studies completed	Estimated dollar savings (in thousands)	Estimated savings rate (percent)[a]
Commissary/clothing store	145	$ 20,170	41
Transport	29	25,993	36
Administrative telephone and communications	96	20,924	35
Education and training	14	11,402	34
Other	59	42,383	33
Supply/warehousing/distribution	109	31,783	32
Audiovisual	65	18,645	31
Equipment maintenance	82	49,475	31
Facilities/grounds/utilities maintenance	251	89,073	29
Management/administrative support	81	8,968	29
Data entry	12	2,234	28
Food service	35	27,196	26
Custodial	201	26,196	26
Motorpool/vehicle maintenance	124	56,283	25
Laundry/drycleaning	50	12,554	24
Multifunction/base maintenance	120	155,515	23
Mail and file	18	462	19
Printing	16	781	16
Manufacturing	1	209	16
Architecture/engineering	2	56	15
Library	24	277	15
Automated data processing	66	3,677	14
Fire protection/guard	54	7,870	14
Health services	7	431	10
Social/community services	0	0	0
All functions	1,661	$612,557	27

[a] Dollar savings as a percent of the estimated original cost of performing the function in-house.

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OFFICE OF CHIEF COUNSEL FOR ADVOCACY

TESTIMONY OF
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U.S. SMALL BUSINESS ADMINISTRATION
BEFORE THE
COMMITTEE ON SMALL BUSINESS
OF THE
U.S. HOUSE OF REPRESENTATIVES
ON UNFAIR COMPETITION

June 28, 1988

Mr. Chairman and members of the Committee on Small Business, I am pleased to appear before you on the issue of unfair competition between small businesses, tax-exempt entities and governmental units. Small businesses first brought this issue to our attention over five years ago and we have been deeply involved in the debate since that time.

As you know, small business delegates to the 1986 White House Conference on Small Business ranked this issue as a top priority among their recommendations for Federal policy change. According to their resolution:

> Government at all levels has failed to protect small businesses from damaging levels of unfair competition. At the Federal, state and local levels, therefore, laws, regulations, and policies should..prohibit unfair competition in which nonprofit tax-exempt organizations use their tax-exempt status and other advantages in selling products and services also offered by small businesses...(and)...prohibit direct, government-created competition in which government organizations perform commercial services.

My testimony represents the views of the U.S. Small Business Administration's Office of Advocacy and not necessarily those of the Administration. It is based on seven years of contact with small business owners and considerable work on this issue.

I would like to highlight the small business perspective on the nature of the problem and briefly describe some recommendations for reforming existing law, particularly in the area of taxation of exempt organizations. Competition by exempt nonprofits with for-profit business is essentially government subsidized competition with the private sector. To the extent that the Federal Government subsidizes nonprofit organization activity through the income tax-exemption, through lower postal rates or through other legal exemptions, nonprofit commercial activity can be carried on with lower cost factors than the for-profit sector. The Internal Revenue Code is the principal mechanism for balancing the need to encourage nonprofit services with the advantages of the exempt status. It is our contention that this balance must be readjusted with legislative change.

Though the tax exemption is of principal concern, other advantages bestowed by government, stemming from the tax exemption, contribute importantly to the problem. The Committee's examination of the issue should look at postal rate subsidies and some regulatory exemptions which may not continue to be necessary or relevant in the changing nonprofit environment.

The Subcommittee on Oversight of the Ways and Means Committee held five days of hearings in June 1987 on the tax treatment of nonprofit organizations. Until that time, the issue of unfair competition had not been comprehensively examined by Congress for 19 years, although it has long absorbed the attention of the small business community. Over one hundred witnesses testified at the Subcommittee's hearings, representing the business, nonprofit; governmental and academic communities. In late March of this year, the Subcommittee proposed specific options for reforming the laws, and received over three-hundred letters in response to its request for comments. Thereafter, the Subcommittee held hearings on the proposed options. Less than one week ago, the Subcommittee released its draft report to the Chairman of the Ways and Means Committee, which recommends some important changes to the nonprofit tax laws and improvements in data collection and analyses. The draft report evidences two major themes: that the increasing diversification of nonprofit activities raises important tax policy problems, and that statutory changes of some sort will be necessary to properly address the problems.

Unfair nonprofit and governmental competition with small business is a public policy issue deserving of immediate attention and reform. This hearing will provide an important forum for small business to discuss the broader aspects of this issue. I commend your efforts to further explore small business complaints in this area and advance the debate.

I. THE EXTENT OF UNFAIR COMPETITION

The extent of tax-exempt competition is reflected in the exponential growth in the service-oriented nonprofit sector, both in numbers and economic strength. From 1946 until the present, the number of active nonprofits have grown more than eightfold, from roughly 100,000 to over 860,000; nearly doubling in the decade between 1968 and 1978 alone. These numbers do not reflect churches and other organizations which are not on the IRS Master Establishment List because they are not required to file.

Statistics from the Bureau of Economic Analysis indicate that nonprofits represent a significant portion of U.S. economic activity. In 1985, the nonprofit sector accounted for approximately 6 percent of the gross national product (GNP), up from $1.2 billion and 1.3 percent of GNP in 1930. The asset holdings of charitable organizations have been estimated to amount to over $331 billion in 1983.

The growth in the nonprofit share of GNP has been accompanied by a deceasing reliance on traditional donative sources of funding. IRS Master File Data show that exempt charitable organizations received 41 percent of their support in 1946, 29 percent in 1975 and 22 percent in 1983 from dues, assessments, private contributions and government grants. Program Service Revenue, which includes related and unrelated business receipts, was estimated to comprise about two-thirds of all revenue derived by nonprofits in 1983. The trend towards more commercial sources of financing is expected to continue, if not increase, in the years to come. The reduction in marginal rates by the Tax Reform Act of 1986 and other changes that were made to the laws governing charitable transfers may influence a slowing in the growth of charitable giving, although it is too early since the tax law changes to see evidence of this.

In many instances, the nonprofit sector's shifting emphasis toward commercial sources of income has blurred the separate identities of nonprofit and for-profit sectors. There is some evidence that the availability of the tax-exemption has served as an inducement for the formation of tax-exempts in some industries.[1] Moreover, established tax-exempts have expanded their commercial activities into markets dominated by for-profit businesses, and many for-profits have entered markets once the exclusive domain of nonprofits.

II. RATIONALES FOR NONPROFIT EXEMPTIONS

A number of theories have been advanced to explain the exemptions governments provide, none of which can justify the use of subsidies to unfairly compete with for-profits. The most common rationale is that nonprofit organizations provide services such as health care, education, and basic research that would not be supplied in the absence of a tax subsidy or the other benefits flowing from exempt status. This "public goods" rationale suggests that nonprofits should be granted tax-exempt status because they provide services that would otherwise have to be provided by the government.

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[1] Henry Hansmann, "The Effect of Tax Exemption and Other Factors on Competition Between Nonprofits and For-profit Enterprise," University of Pennsylvania, December 1982.

This theory may be valid in relation to public charitable functions, such as the provision of goods or services to the poor or disadvantaged, where in the absence of such an exemption, the marketplace may not otherwise fill critical needs. It must be questioned, however, when used to justify an exemption for activities involving the sale of goods or services which are or would be provided by the for-profit sector. That nonprofits are increasingly competing with for-profit firms in a wide range of activities is evidence that many are not supplying the "public goods" which small business would not otherwise provide.

Another justification commonly advanced is the so-called "quality assurance" rationale, which posits that nonprofits provide higher quality services where consumers are ill-equipped to judge the quality of services offered before purchase. Although this rationale has superficial appeal, there is no empirical evidence that nonprofits provide higher quality services than for-profits. On the contrary, nonprofits are often motivated by the same factors as for-profits. They also may be under considerably less public scrutiny because the nonprofit form of business usually carries fewer demands for disclosure or reporting. The for-profit sector, on the other hand, must make its case to the stock market, government regulatory agencies, and consumer advocate organizations. Moreover, granting nonprofits a subsidy, which diminishes effective competition by for-profit business, is an inefficient way to achieve higher quality services. It would be more consistent with this objective to permit businesses to evenly compete with nonprofits in order to stimulate a level of competition vital to ensuring higher quality products and services.

III. COMPETITIVE ADVANTAGES OF NONPROFITS

To small businesses, the most distinguishing feature of tax-exempts is not the goods they sell or services they provide, the prices charged for these goods or services, or the markets served, but the advantages they receive through tax and other government subsidies. Government subsidies, both direct and indirect, provide nonprofits with competitive advantages in areas where for-profits are selling, or would like to sell, the same good or service.

It is important to recognize that the small business community does not want to curtail the many necessary services provided by nonprofits, nor do they want to limit competition per se. Subsidies and other advantages are justified when they fill gaps in the marketplace or assist in meeting important societal needs. Indeed, the relationship between many nonprofits and for-profits is symbiotic; nonprofits often enhance the quality of life and community business environment, and small employers often contribute of their time and resources to charities. Small firms do object, however, when nonprofits engage in competing activities and operate under a different set of rules. For small business, the issue is one of fundamental fairness.

A. Tax-exemption

The principal advantage realized by nonprofit organizations when competing with for-profit businesses derives from their Federal income tax exemption. Under the Internal Revenue Code (Code), tax exemption is granted to 25 different categories of organizations; including charitable, educational, and scientific institutions (Section 501(c)(3), civic leagues (Section 501(c)(4), business leagues (Section 501(c)(6), and social clubs (Section 501(c)(7)). It is important to note that there is a distinction between nonprofit organizations and tax exempt organizations, the former being any organization prohibited from distributing earnings or profits to persons exercising control over it. However, most nonprofits are exempt organizations. The charitable nonprofit organization, as defined in Section 501(c)(3), is the largest tax-exempt category, representing over 43 percent of all active nonprofits in 1985.

The Code does not require nonprofits to abstain from engaging in commercial activities as a condition of tax-exempt status; the primary purpose of an organization and not its activities determines its eligibility for tax-exemption. Nonprofits, particularly Section 501(c)(3) organizations, can and do engage in a wide variety of almost unlimited business activities, retaining their tax-exempt status as long as this income is related, or if unrelated, taxed.

In an effort to alleviate unfair competition known to stem from commercial activities, the 81st Congress in 1950 developed the "unrelated business income tax" (UBIT), which is codified in Section 511 of the Internal Revenue Code. The UBIT was intended to strike a balance between income derived from activities that are unrelated to an exempt organization's function, and income derived from activities that contribute importantly to an organization's function. Under the UBIT, income from a regularly conducted trade or business is taxable only if it is not "substantially" related to the performance of the function(s) upon which the nonprofit's exemption is based. Income "substantially related" to the exempt function is believed to be an extension of the exempt function performed by the entity and left untaxed. Specific activities were also expressly excepted from the scope of the tax; including, certain research activities and activities carried on substantially by volunteers, activities conducted "primarily for the convenience of members, students, patients, officers, and employees," or activities involving the sale of donated merchandise. Income from passive sources was excluded as well.

In recent years, the explosive growth in the nonprofit sector and its expansion into commercial enterprise have challenged the continued adequacy of these laws and the underlying enforcement mechanisms. A great many commercial activities of nonprofits today escape taxation, either because they fall within one of the several exceptions provided under UBIT, because they are considered to be related to the exempt organization's function, or because they are not properly reported to the IRS.

According to IRS statistics, although the exempt community holds total assets of $331.2 billion and accounts for approximately 6 percent of GNP, only 3 percent of the approximately 900,000 active exempt organizations file Income Tax Form 990-T, which reports unrelated business income over $1,000. In recent years, approximately one-third of the Forms 990-T examined annually by the IRS were delinquent returns -- a much higher proportion than business returns. Additionally, approximately 60 percent of the forms report a loss. According to the IRS, some of these returns reflected an actual economic loss from unrelated business activity, but a substantial portion of the reported losses were attributable to underreporting of income and overreporting of expenses. This observation is bolstered by aggregate data from examinations of Form 990-T, which reflect proposed tax increases after examination that annually range from 30 to 50 percent of the total tax calculated by organizations on Form 990-T.

Much of the difficulty lies with the "substantially related" test, which permits many activities that compete directly with small business to avoid taxation. Recent data showing that few tax-exempt organizations reported unrelated business income during a period of increased reliance on commercial income is evidence of this fact. Indeed, since attention has been drawn to this issue, UBIT revenues have increased four-fold; from about $30 million in 1985 to $120 million in 1987.

B. Postal Rate Subsidies

Another principal competitive advantage is the availability of federally subsidized mail rates for use in marketing goods and services. Currently, there are no restrictions on the amount of advertising content which can be contained in nonprofit third-class postage, and regardless of the amount of advertising content, the rate of postage is not affected. In particular, the third-class rate for nonprofit mail presorted to the carrier is 5.3 cents, as opposed to 10.1 cents for a for-profit. Business mail presorted to five digits is available at a cost of 7.6 cents to nonprofits and 13.2 cents to for-profit businesses. The difference in cost for all other bulk third-class mail is 16.7 cents for for-profits and 8.4 cents for nonprofits.

The special nonprofit second-class postal rates are increased for advertising content if the content exceeds 10 percent, but the increase is less than that required for business second-class postage. In a study conducted by the U.S. Postal Rate Commission pursuant to the Budget Reconciliation Act of 1985, 45 percent of nonprofit second-class mail was found to contain more than 10 percent advertising content. Of the nonprofit third-class mail, 28 percent was found to contain advertising.

The total revenue foregone through subsidized postage is projected to be $436 million in 1989 as a result of recent Congressional action in the House. Of this, an estimated $56 million is accounted for by nonprofit second-class postage and $328 million by nonprofit third-class postage. For 1987, $650 million in revenue was estimated to be foregone by the subsidies, and current year revenue losses are estimated at $556 million.

The amount of the subsidy to be provided for favored nonprofit mail in fiscal year 1989 reflects the exclusion from rates of all overhead and other administrative expenses not directly allocable to that mail. This subsidy is currently offset by direct appropriations, and after April 3, 1989, by the increased rates paid by for-profit businesses. Under a new method of accounting for this subsidy recently adopted by Congress, the so-called equal-markup method, the appropriations for the postal subsidies decreases, causing a corresponding increase in the business rate. If the appropriations are phased-out and the Postal Service is not permitted to adjust its nonprofit postal rates, the for-profit mailers will be required to assume all costs previously covered by the appropriation. This is a clear and increasing subsidy by for-profit mailers of nonprofit mail.

C. Other Statutory and Legal Advantages

Nonprofits are frequently exempted from, or receive special treatment under other Federal requirements; including, Social Security, unemployment insurance, minimum wage, securities, bankruptcy, antitrust, and copyright requirements. These exemptions are discussed more fully in the Attachment. Tax-exempts also gain an advantage from numerous state and local exemptions, exemptions from income, sales, business and occupation, and property taxes.

D. The "Halo" Effect

Apart from legal advantages, nonprofits gain intangible advantages in goodwill because public perception generally confers a higher status to a product bearing a charitable organization's imprimatur -- even though similar products at similar prices are available in the for-profit sector. This "halo" effect carries over into more concrete advantages, such as public service announcements and other free advertisements that are used to market a commercial service or a product bearing a nonprofit's seal.

IV. INDUSTRY FOCUS OF THE PROBLEM

The preponderance of small business complaints have been directed at the surge in commercial activities engaged in by hospitals and higher education institutions, which together account for almost 70 percent of the nonprofit sector. Relative to other tax-exempt organizations, both rely heavily on business receipts.[2] In health-related services, statistics show that business receipts comprise as much as

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[2] "Tax Policy, Competition Between Taxable Businesses and Tax-Exempt Organizations,": U.S. General Accounting Office, Briefing Report to the Joint Committee on Taxation, U.S. Congress, GAO/GGD-87-40BR, February 1987, Appendix IV.

56 percent, or $23 billion, of the total revenue derived. Similarly, business receipts of schools and colleges totaled $6 billion, or 30 percent of overall revenue. Hospitals, educational institutions and publicly supported charities, together with organizations that supported such charities, dominated the financial statistics. These organizations had $216 billion in revenue and $319 billion in assets, more than 96 percent of the total revenue and assets of all nonprofit organizations.

Tax-exempt health care providers who engage in the sale of ancillary goods and services readily available from for-profit providers are a significant concern. These activities commonly escape taxation, because they fall under the exemption from UBIT for activities conducted "primarily for the convenience of patients." For example, hospitals' operations of ambulance services, medical clinics, home health care, and rehabilitation services have been found to be tax-exempt. Hospitals have also engaged in nontraditional businesses through affiliates; including commercial cleaning, interior decorating, computerized billing for doctors, catering, and data processing.[3]

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[3] James J. McGovern, "Restructured Nonprofit Hospitals," Tax Notes, April 27, 1987, p. 406.

Complaints involving universities and colleges have focused on research and testing activities, and, as in the case of hospitals, sales of incidental products and services "for the convenience of students." Of the $132 billion estimated to be spent in the U.S. for research and development in 1988, 14 percent or $19 billion goes to universities, colleges, and nonprofit scientific organizations.[4] Research by a university, college, or hospital is completely exempt from the UBIT, regardless of whether it is related to any educational or scientific purpose (I.R.C. section 512(b)(8)). In Nevada, a particular state university underbid a small business and won several marketing and opinion polling contracts; in Pennsylvania, a university professor, working on behalf of the University, earned $60,000 a month by testing households for radon; and in Louisiana, a New Orleans university laboratory conducted asbestos analysis for industry. Undoubtedly, there is a legitimate need for university-sponsored basic research, yet there are few instances in which revenues from applied research activities and research activities with potential commercial application should not be taxable.

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[4] Science and Technology Data Book: 1988 (NSF 87-317), Washington, D.C., 1987.

V. SUGGESTIONS FOR FEDERAL POLICY CHANGES

The current laws governing nonprofits have not kept pace with the changing nature of the nonprofit and for-profit communities. The broad contours of the exemptions provided to nonprofits and the inadequacies of safeguards designed to prevent unfair competition, such as the "substantially related" test, have contributed to the serious problem today. Not only have the exemptions provided nonprofits with public tax subsidies, but a means to cross-subsidize their functions through competition with small business. There is seldom a dispute over the benefits that nonprofits bring to our country: this debate centers around the most efficient means to pay for those benefits.

The Congress should strive to reform existing laws and policies to most effectively ensure that the activities of nonprofit organizations further the legitimate purposes for their special status. While the laws should encourage the increased production of undersupplied goods and services, they should not discourage the taxable sector from providing similar goods and services. Undoubtedly, there will always be instances where nonprofits will overlap in the provision of goods and services with the for-profit sector, but the laws should be designed to keep these instances to a minimum. In cases where an overlap is unavoidable, the laws should strive to treat nonprofit organizations in the same manner as the business community.

A. Tax Related Changes

Advantages nonprofits receive through special treatment under Federal, state and local laws, including antitrust law, sales tax, property tax and postal rates, find their genesis in the tax exemption. Accordingly, the solution to the problem of unfair competition lies, first and foremost, in addressing inadequacies of Internal Revenue Code provisions. These provisions have not been examined extensively since 1969.

In sum, we recommend that: (1) the "substantially related" test be tightened to require that a commercial activity, as a condition of nontaxability, fulfill the exempt purpose of the organization rather than merely "contribute importantly" to that purpose; (2) the exception provided "for the convenience of students, faculty and patients" be repealed; (3) the exemption for research revenues be confined to basic research; (4) a cap be placed on the commercial income which can be generated tax-free from a nonprofit organization before it loses its primary purpose; and (5) a procedure be established at the Service for formally voicing complaints of unfair competition by for-profit businesses.

The "substantially related" test should be tightened because it has failed to fulfill its essential function of protecting small business from unfair competition. In particular, Congress should better define the "substantially related" test by exempting from taxation only those income-producing activities so fundamental to the organization's exempt purpose as to be a mere extension of it, capable of standing alone as tax-exempt activities. This approach would clarify the borders of permissible activities for managers of tax-exempt organizations, enforcement officials and the courts, consistent with the exempt organization's primary mission. As a result, both compliance with the UBIT and its administration would improve.

With regard to research, the exemption should be confined to basic research, i.e., research that furthers knowledge of the subject under study, rather than its practical application. This would limit the exemption to research which is unlikely to be provided by, and compete with, the private sector.[5] The exemption could be confined to basic research in several ways. Guidelines as provided by the Code of Federal Regulations and OMB Circular A-11 could be used to construct a definition for basic research. Definitions of basic research are also provided for the University Basic Research Credit (I.R.C. § 41(e)). To avoid definitional problems, the Code could be amended to include as taxable income research funds from contracts which require the results to belong to the research sponsor. Income from research projects in which the results are freely available to the public could remain tax-exempt, while research performed under a contract or institutional policy that would delay publication of the results or require the copyright or patent to be transferred to the research sponsor could be taxable. The latter approach would ensure that research which is subject to tax would most likely have practical application or potential for practical application.

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[5] 48 CFR 31.205-18(a) Federal Acquisition Regulations; OMB Circular A-11, Section 44.3., p. 98, May 28, 1986.

I also support the development of a ceiling, which if exceeded, would shift the burden of proof to the organization to show it is still deserving of tax-exempt status. In the absence of a clearly defined ceiling, nonprofits can and do engage in an almost unlimited amount of commercial activity with little accountability to their original purpose. As noted, in 1983, dues, assets, and contributions constituted only one-third of the total income of nonprofit organizations; two-thirds came from program service revenue, which includes both taxable and nontaxable income.

The Subcommittee on Oversight's recent draft report makes many recommendations for reforming the UBIT. Some of these recommendations, such as that to repeal the "convenience" exceptions, will assist in limiting the circumstances under which unfair competition can result. Other recommendations, however, merely codify current law, continuing exceptions to the UBIT that have contributed to the current problem.

B. Better Data Collection and Analyses

Representatives of both tax-exempt and taxable organizations agree that data collection concerning nonprofit activities is inadequate. Currently, the nonprofit business and informational tax forms (Forms 990-T and 990), the best instruments for collecting data on nonprofit activity, do not request sufficient information to determine the amounts earned from nonprofit commercial activity or the type of activities in which they engage. These forms also do not distinguish between activities that are related, unrelated, or excepted from the UBIT.

I recommend that specific guidelines be developed for modifying the tax-exempt data collection instruments in the Technical

Corrections Act currently before Congress. In particular, Form 990 should separate commercial income by the business activity codes into categories defined by the Internal Revenue Code (i.e. related, unrelated or excepted). Similarly, Form 990-T should link the source of unrelated income to the amount it generates. General recommendations make by the Oversight Subcommittee in its recent draft report would go far towards accomplishing this objective. The Office of Advocacy has developed specific proposals to modify the forms which we would be happy to share with the Committee.

Additional data are also needed on the amount of tax subsidies granted to tax-exempt organizations. The Congressional Budget Act of 1974 (P.L. 93-344) requires a listing in the annual budget analysis of tax expenditures, which are defined to include "revenue losses attributable to provisions of Federal tax laws which allow a special exclusion, exemption or deduction..." Revenue losses for the tax-exempt sector, however, have not been estimated by the Federal Government in the same manner as are the expenditures for other tax subsidies.

C. Postal Rate Subsidies

With regard to postal rate subsidies, I recommend that Congress seriously consider the recommendations proferred by the Postal

Rate Commission in their June 18, 1986 Report to the Congress. For second-class postage, the Commission recommended that the subsidy be continued for the editorial portion of publication only, and that the advertising portion pay the regular rates. Adoption of this recommendation would have the effect of equalizing advertising rates of nonprofit and commercial second class publications. Additionally the Commission recommended retaining the current rule which allows up to 10 percent advertising content without increasing those rates.

For third-class mail, the Commission recommended that the eligibility initially depend on whether the advertising concerns products, services, gift-premiums, or travel and entertainment. If the item advertised is a product, service or gift-premium the Commission recommended applying a test based upon the principles of the unrelated business income test. The Commission would tighten the restrictions provided under the "substantially related" test, however, by requiring the advertised product to be actually manufactured or the service provided by members or beneficiaries of the organization in order to receive preferred treatment. Similarly, in the case of services, the Commission recommends that any involvement by an ineligible person would disqualify the mailing for preferred rate purposes. For example, a nonprofit could not solicit its members to sign up for a certain credit card using subsidized mailing, since the credit card company is a necessary joint producer of the service.

The Commission further recommends treating gift-premiums consistent with the manner in which those items have been treated under case law arising under the unrelated business income tax. Accordingly, premiums that are offered in return for contributions approximating the value of the premium are not to be given favored treatment. Further, all promotion of insurance and travel would be denied preferred rates.

IV. CONCLUSION

The success of small business and its continued ability to provide opportunity for entrepreneurs and job growth for America depends to a large degree on the business environment in which they function. Tax and other advantages granted nonprofits engaging in commercial activity have placed many small businesses at a competitive disadvantage. It has deterred for-profit businesses from entering fields whose markets and technologies have expanded beyond the point necessitating subsidies, and brought tax-subsidized competition to additional markets in which nonprofits have expanded their commercial activity. The vague contours of the "substantially related" test and the broad exceptions provided in current law have permitted nonprofits to enjoy advantages in conducting activities which were never contemplated by Congress in carving out their original exemption. The distinction between the two sectors has become blurred, in some cases beyond recognition.

I commend the Subcommittee for providing a forum to discuss this important issue. Small businesses do not seek to eliminate competition. They seek instead a competitive environment in which all participants play by the same rules.

ATTACHMENT

I. Exemptions from FICA and FUTA

A. Social Security

The Social Security Act (SSA) requires the creation of trust funds from which insurance benefits are to be paid. As codified in 42 U.S.C. § 401, the Act established the Federal Old-Age and Survivors Insurance Trust Fund and Federal Disability Insurance Trust Fund. Funding for these programs is provided through various employment taxes as set forth in 26 U.S.C. § 3111. Because certain services performed for nonprofits are not treated as employment relationships, however, they are exempted from the requirements of the SSA.

For purposes of the SSA, services which are performed for a church or church-controlled organization electing treatment under 26 U.S.C. § 3121 (w) are excluded from the definition of "employment." This exclusion, however, does not include services performed in an unrelated trade or business (42 U.S.C. § 410 (a)(8)(B)). Under § 3121 (w), any church or church-controlled organization may elect to be excluded from employment for purposes of 42 U.S.C. § 401 if the organization is opposed to the payment of the tax for religious reasons.

Another exemption excludes work performed by students for schools or student organizations. Certain domestic services performed by an enrolled student, in a local college club or local chapter of a college fraternity or sorority, are expressly excluded from the definition (42 U.S.C. § 410 (a)(2)). Moreover, all services performed for a school, college, or university by a student enrolled and regularly attending classes are excluded (42 U.S.C. § 410 (a)(10)).

B. Unemployment Insurance

The Federal Unemployment Tax Act imposes an excise tax on all employers, which is based on a percentage of the total wages paid to employees. The tax provides funding for Federal unemployment benefits (26 U.S.C. § 3301).

As under the Social Security Act, the tax only applies to employment arrangements. Exceptions are provided with respect to: (1) services performed for a religious, charitable, educational, or other 501 (c)(3) organization (26 U.S.C. § 3306 (c)(8)); (2) domestic services in a local college club or local chapter of a college fraternity or sorority, as long as the quarterly cash remuneration does not exceed $1,000 (26 U.S.C. § 3306 (c)(2)); (3) services to other tax-exempt organizations, if the cash remuneration is less than $50; (4) services provided to a school by a student, and (5) services provided outside a school for which credit is given (26 U.S.C. § 3306 (c)(10)). The term "wages" as defined in the Act, includes all remuneration except payments made to or on behalf of an employee or his beneficiary from certain tax-exempt trusts, provided the payment is made to the employee as a beneficiary (26 U.S.C. § 3306 (b)(5)(A)).

II. Exemptions From Economic and Trade Regulations

A. Price Discrimination

The Robinson-Patman Anti-discrimination Act was enacted to prohibit discriminatory practices between different purchasers in terms of price, services, or facilities (15 U.S.C. § 13 (a)). Two years after its passage, the law was amended to exempt certain nonprofits. Specifically, § 13c of the Act exempts purchases of supplies for use by schools, colleges, universities, public libraries, churches, hospitals, and charitable institutions which are operated for profit (15 U.S.C. § 13c).

The word "purchases" as used in the Act has been construed liberally to include the party selling to the nonprofit institution. Furthermore, "supplies" has been held to include any item required to meet the needs of the nonprofit institution (Logan Lanes, Inc. v. Brunswick Corp., 378 F.2d 212, (1967)). The net result of the exemption has been to remove any restrictions on price discrimination practices for transactions that involve sales to nonprofit institutions.

B. Unfair Competition

The Federal Trade Commission (F.T.C.) was established in 1914 to regulate and prevent unfair or deceptive acts affecting commerce (15 U.S.C. § 45 (a)(1)). The FTC was empowered to enjoin or otherwise prohibit persons, partnerships and corporations from engaging in such practices (15 U.S.C. § 45 (a)(2)). Under the Act, the term "corporation" is defined to include any company, trust or association organized to "carry-on business for profit" (15 U.S.C. § 44). The definition serves generally to exclude nonprofits from the scope of the protective provisions.

The above definition has been interpreted to provide a shield only for truly eleemosynary institutions and not a blanket exclusion for nonprofits (*Community Blood Bank, Inc. v. FTC*, 405 F2d 1011 (1969)). While protection of nonprofits is considered legitimate in terms of protection from unwarranted governmental intrusion, the nonprofit corporate veil can be pierced when needed to protect the public interest (*Ohio Christian College*, FTC Dkt. 8820, CCH Trade Reg. Rep 20017, (1972)).

C. Securities

In 1933, Congress passed the "Securities Act of 1933" to protect the public from fraud and abuse associated with blue sky schemes (15 U.S.C. § 77a). To achieve its purpose, the Act replaced the prevailing philosophy of *caveat emptor* with one of full disclosure; the rationale being that full disclosure would lead to informed decisionmaking. The legislation imposed strict reporting requirements on the issuance of securities (15 U.S.C. § 77a *et*. *seq*).

Certain securities listed in § 77c of the Act, however, were specifically exempted from these reporting requirements. These include securities issued by an organization operated exclusively for religious, educational, benevolent, fraternal, charitable, or reformatory purposes. The only limitation on the exemption is that the nonprofit-issuer must not be organized for pecuniary profit or otherwise operate in a manner inconsistent with the terms of the exemption.

III. Miscellaneous Provisions

A. Copyright

The owner of a copyright is granted the exclusive right to reproduce the copyrighted work, prepare derivative works based on it, distribute copies of it to the public, perform it, and display it (17 U.S.C. § 106). The general rule, however, is subject to certain exceptions, including: (1) the use of copyrighted material during face-to-face teaching activities by nonprofit teaching institutions; (2) secondary transmissions of primary transmissions, made by a nonprofit organization which is not a cable system and without commercial advantage and charge (17 U.S.C. § 111 (a)(4)); (3) the reproduction of 30 copies of copyrighted material by a nonprofit educational institution, provided no copies are made from these copies and all but one copy is destroyed within one year (17 U.S.C. § 112 (b)); and the (4) reproduction of copyrighted material by a public broadcasting agency which engages in the activity with a nonprofit institution (17 U.S.C. § 118 (d)(3)).

B. Bankruptcy

Nonprofit organizations receive special treatment under Federal bankruptcy law, which limits the circumstances under which they can be forced into receivership. According to Section 303 (a) of Title 11, an involuntary case in bankruptcy may be commenced only under Chapter 7 or Chapter 11 against a qualified party. The Chapter 7 provisions, concerning liquidation of assets, applies to individuals, while the Chapter 11 provisions, which provides for business reorganizations, applies primarily to corporations. Specifically excluded from those entities subject to involuntary cases, however, are organizations which are not a "moneyed business, or commercial corporation" (11 U.S.C. § 303 (a)).

Courts interpreting the phrase "moneyed business, or commercial corporation" have limited the meaning to entities organized for profit (In Re Allen University, 497 F.2.d 346 (1974)), and have affirmatively held that charitable and benevolent associations, not operated for profit, are not subject to involuntary bankruptcy proceedings (In Re Michigan Sanitarium & Benevolent Association, 20 F. Supp 979 (D.C. Mich) (1937)).

U.S. SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

OFFICE OF CHIEF COUNSEL FOR ADVOCACY

June 30, 1988

Honorable Joseph M. McDade
U.S.House of Representatives
2370 Rayburn House Office Building
Washington, D. C. 20515-3810

Dear Congressman McDade:

During the testimony of Lester M. Salamon in the second panel of your hearing on Unfair Competition, June 28, 1988, you asked for the source of our estimate concerning Program Service Revenue received by nonprofits. On page 4 of our testimony we indicated that Program Service Revenue, which includes both related and unrelated business receipts, comprised about two-thirds of all revenue received by nonprofits in 1983.

Our figure was derived from the IRS Statistics of Income Bulletin (Winter 1985-86, Volume 5, Number 3, P. 21), which indicated that $147 billion of the estimated $224 billion in total revenue derived by nonprofits in 1983 were received from Program Service Revenue. A substantial share of the Program Service Revenue, $118.8 billion, was from hospitals and educational institutions which were excluded from Mr. Salamon's Study. The IRS estimate was determined by a random probability sample of 1983 unaudited information returns (Forms 990) stratified by asset level. The sample consisted of 4,894 returns, and was drawn from a sample frame of 105,391 organizations.

I hope this responds to your inquiry concerning our data. If I can be of further assistance, please feel free to contact me at 653-6533.

Yours very truly,

Frank S. Swain
Chief Counsel for Advocacy

cc: Honorable John LaFalce
Chairman

For Release Upon Delivery
Expected at 9:30 A.M.
June 28, 1988

STATEMENT OF
ADELBERT L. SPITZER
SPECIAL ASSISTANT TO THE ASSISTANT SECRETARY
(TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
COMMITTEE ON SMALL BUSINESS
U.S. HOUSE OF REPRESENTATIVES

Mr. Chairman and Members of the Committee:

I am pleased to have this opportunity to present the Treasury Department's views concerning the question of competition between tax-exempt organizations and taxable businesses, particularly small businesses.

As you know, the issue of "unfair competition" between tax-exempt organizations and taxable businesses has been the subject of considerable debate during the past several years and is currently being considered by the Oversight Subcommittee of the House Ways and Means Committee in its review of the unrelated business income tax ("UBIT") that applies to tax-exempt organizations. The Treasury Department has testified before the Oversight Subcommittee twice on this subject during the past year. On June 22, 1987, we testified with respect to general issues raised by the UBIT and on May 9, 1988, we commented on a list of "discussion options" prepared by the Subcommittee.

We believe this Committee's consideration of the issue of competition between tax-exempt organizations and taxable businesses is an important part of the current debate. Although federal income tax exemption is, of course, a significant benefit enjoyed by tax-exempt organizations, it is by no means the only governmental subsidy provided to such organizations. An analysis of the effect on competition of tax exemption is incomplete unless it also considers both the other benefits granted by the federal government (such as reduced postal rates and the ability to issue tax-exempt bonds) and those granted by state and local governments (such as real estate tax exemption). In addition, although changes to the federal income tax law undoubtedly would affect the competitive balance between taxable and exempt firms,

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there are a variety of other means of affecting this balance -- not all of which would involve legislation. This Committee is well situated to undertake a broad review of this important subject and to effectuate significant beneficial changes.

My testimony will focus primarily on the UBIT, the rationale for income tax exemption, and the effect on competition of income tax exemption and other governmental subsidies. I will begin by describing the overall dimensions of the tax-exempt sector of our economy. Second, I will describe the structure of the UBIT, together with the historical developments that led to the enactment of the tax in 1950. Third, I will outline the tax policy considerations that are relevant to a review of the UBIT. Fourth, I will summarize briefly Treasury's recommendations with respect to the UBIT. Finally, I will offer several suggestions as to how the interests and expertise of this Committee can best be used to address the issue of competition between taxable and tax-exempt firms.

I. Dimensions of the Tax-Exempt Sector

A. General Description of Tax-Exempt Organizations

It is important to note that there is a distinction between nonprofit organizations and tax-exempt organizations. A nonprofit organization is an organization that is prohibited, generally by its organizational documents or state law, from distributing profits or net earnings to individuals who exercise control over it, such as its directors, officers or members. A nonprofit organization is not prohibited from earning a profit but, rather, is prohibited from distributing its profits to individuals in their private capacity.

Although most nonprofit organizations are exempt from federal income tax, the Internal Revenue Code (the "Code") does not by its terms grant tax-exempt status to all nonprofit organizations. Instead, the Code exempts from tax a diverse group of organizations, including religious, charitable, scientific and educational organizations; social welfare organizations; labor and agricultural organizations; business leagues; social clubs and many others. (see Figure 1.) Certain of these organizations -- primarily religious, charitable, scientific and educational organizations described in section 501(c)(3) of the Code -- are not only exempt from tax, but also are eligible to receive tax deductible contributions.

The Code does not prohibit tax-exempt organizations (other than private foundations) from engaging in business activities for profit. If such business activities are substantially related to the tax-exempt purpose of the organization, such as the operation of a dining hall or a dormitory by a college, any profit from the business is exempt from tax. If a business is unrelated to the exempt purpose of the organization, however, such as the operation of a manufacturing facility by a university, any profits from the unrelated business are subject to income tax, generally to the same extent as the profits of a taxable business. The fact that an organization is required to pay tax on its unrelated business income does not, in general, affect the organization's tax-exempt status. Nonetheless, if the operation of unrelated businesses becomes the primary purpose of a tax-exempt organization, and thus its exempt function becomes a secondary purpose, the organization will cease to qualify for tax exemption under the Code.

B. Size of Exempt Sector

Tax-exempt organizations make up a large, diverse and growing sector of the U.S. economy. Currently, there are approximately 1.2 million exempt organizations, including 340,000 churches exempt under section 501(c)(3); nearly 390,000 educational, charitable, scientific, and religious organizations (other than churches) also exempt under section 501(c)(3); 130,000 civic leagues and social welfare organizations exempt under section 501(c)(4); and 355,000 mutual benefit organizations such as labor unions, chambers of commerce, mutual insurance companies, organizations of war veterans, and cemetery companies, also exempt under section 501(c).

In the last 20 years, there has been substantial growth in the nonprofit sector. During this period, the number of active tax-exempt organizations included in the Internal Revenue Service Master File ("IRS Master File")1/ more than doubled, from about 410,000 in 1968 to about 866,000 currently.

C. Economic Activity

A significant portion of U.S. economic activity occurs in the exempt sector. The Bureau of Economic Analysis estimated that current operating expenditures of nonprofit organizations totaled $239 billion in 1985, or six percent of GNP. In 1984, employees of nonprofit organizations (both paid and volunteer) accounted for ten percent of total hours worked in the U.S. economy, and paid employees of nonprofit organizations accounted for six percent of total hours worked by paid employees.

1/ The IRS Master File of Tax-Exempt Organizations is a compilation of all organizations which have applied for and received recognition of tax-exempt status from the Internal Revenue Service. Since churches are not required to apply for tax exemption, most do not do so, and very few are listed on the IRS Master File. Of the 1.2 million estimated tax-exempt organizations referred to in the text, 866,000 are active tax-exempt organizations reported on the IRS Master File and 340,000 are churches that are not reported on the IRS Master File.

Much of the economic activity of the nonprofit sector is made up of public charities and social welfare organizations that provide health, education or research services. In 1984, 47 percent of current operating expenditures of nonprofits were accounted for by health service organizations, and 22 percent by educational and research organizations. In turn, hospitals accounted for the bulk of economic activity in the nonprofit health service sector, and private elementary and secondary schools and private colleges and universities accounted for the bulk of economic activity in the nonprofit education and research sector. In contrast, the broad range of mutual benefit organizations exempt under provisions other than section 501(c)(3) and section 501(c)(4) accounted for only 10 percent of current operating expenditures of all nonprofits in 1984.

D. Funding for the Nonprofit Sector

Nonprofit organizations finance their activities through a number of sources: government grants, private donations, fees for services, operation of businesses, and investments yielding income such as interest, dividends, rents, or royalties. The relative reliance on these different revenue sources differs greatly among subsectors of the nonprofit community. For example, while religious organizations rely mainly on private contributions, health service organizations rely on fees and charges for most of their funding, and social service organizations rely most heavily on government grants. (See Table 1.)

The proportion of revenue derived from various sources also varies with the size of nonprofit organizations. Data for 1983 indicate that with respect to "public charities" (section 501(c)(3) organizations that are not private foundations), the greater the asset size of the organization, the lesser its reliance on government grants or private contributions, and the greater its reliance on fees and charges and other revenue sources. (See Table 2.)

There is some evidence that nonprofits have increased their reliance on income-producing or commercial activities in recent years. IRS Master File data show that, in 1946, organizations exempt under section 501(c)(3) obtained 59 percent of their support from business receipts, interest, dividends, rents, royalties, sales of assets and miscellaneous sources other than government grants, private contributions, dues and assessments; 71 percent from such sources in 1975; and 78 percent in 1983.2/

2/ Survey data from organizations such as the Urban Institute, Partners for Livable Places, the Rockefeller Brothers Fund, and the National Assembly provide supporting evidence of a trend toward increasing commercial activity by nonprofits.

For a number of reasons, however, the available IRS data do not give a definitive picture of nonprofit funding trends. First, requirements for filing Form 990, the information return filed by tax-exempt organizations, have changed over time, and the form has been subject to reporting and coding problems. Specifically, because Form 990 is an information return that does not result in tax liability, improper and erroneous information is reported more frequently than on forms that require computation of tax liability. Coding problems result from the lack of detailed statistical tests to check for reporting accuracy. Second, unrelated business income is reported on a separate form (Form 990-T), income from for-profit subsidiaries of nonprofit organizations is reported on the corporate income tax return (Form 1120), and income from partnerships is reported on the partnership return (Form 1065). Each of these forms would need to be matched with the Form 990 of the tax-exempt entity in order to obtain a comprehensive picture of the organization's commercial activity.

E. The Unrelated Business Income Tax (UBIT)

As noted above, tax-exempt organizations are required to pay income tax on their unrelated business income. In fiscal year 1985, approximately three percent of all tax-exempt organizations on the IRS Master File of Exempt Organizations filed Form 990-T in order to report unrelated business income. The amount of unrelated business tax revenue has increased sharply during the past several years, from about $30 million in fiscal year 1985 to $53 million in fiscal year 1986 to $120 million in 1987. Preliminary data suggest another sharp increase for 1988. (During this same period, the number of Forms 990-T processed increased each year by only approximately 15 percent.) This rapid rise in the UBIT revenue has likely resulted from a combination of increased compliance and increased unrelated activity.

Data for 1984 indicate that most unrelated businesses have a small amount of gross unrelated business income. Only 18 of the roughly 25,000 nonprofits filing in 1984 reported unrelated business income over $3 million, 56 reported unrelated business income between $1 million and $3 million, and 1,412 reported unrelated business income between $100,000 and $1 million. In addition, fewer than one third of the 25,000 nonprofits reporting unrelated business income had positive taxable income, and were therefore subject to tax.

The amount of tax reported on Form 990-T, however, does not present a complete picture of tax paid by exempt organizations on unrelated businesses. As noted above, many exempt organizations operate unrelated businesses in taxable subsidiaries that file corporate income tax returns. Under current reporting requirements, it is not possible to identify the returns of taxable corporations owned by exempt organizations or to correlate such returns with those of their parents. Thus, no data are available with respect to the amount of tax paid by subsidiaries of exempt organizations.

II. Current Law

A. Historical Development

Prior to 1950, the law was unclear as to the taxation of unrelated business activities of tax-exempt organizations. Under the "destination of income" rule described below, the majority of courts had held that a tax-exempt organization did not lose its tax exemption by virtue of the conduct of an unrelated business so long as the profits from the business were dedicated to charitable purposes. In fact, a "feeder" organization that engaged exclusively in commercial, non-exempt activities was treated as exempt from tax so long as all the profits from the organization were distributed to an affiliated charitable organization. The majority view was thus that the destination of income, not its source, was the appropriate test for tax exemption. Because of the liberality of the destination of income rule, prior to 1950 a number of charitable organizations carried on unrelated businesses -- businesses that often competed directly with taxable companies.

In 1950, Congress responded to the operation of unrelated businesses by exempt organizations by enacting a tax on such organizations' unrelated business income. The legislative history of the Revenue Act of 1950 indicates that Congress was primarily concerned with the issue of "unfair competition." Both the House and Senate reports state:

> The problem at which the tax on unrelated business income is directed is primarily that of unfair competition. The tax-free status of [section 501(c)] organizations enables them to use their profits tax-free to expand operations, while their competitors can expand only with the profits remaining after taxes.

As part of the Revenue Act of 1950, Congress also enacted a Code provision pertaining to "feeder organizations," which provides that an organization carrying on a trade or business for profit shall not be exempt under section 501 on the ground that all of its profits are payable to another exempt organization.

In addition to directly operating a commercial enterprise, some tax-exempt organizations engaged in transactions which became popular during the late 1940s -- the "sale and lease-back" of a taxable business to an exempt organization. In such transactions, a charitable organization would acquire a property (such as real estate) from a business, often borrowing to finance the entire acquisition, and would then lease the property back to the seller under a long-term lease. The result of the transaction was that the seller received capital for use in its business, the seller's taxable income was substantially reduced by the deductible rent, and the charity received the difference between the rental payments and its loan amortization payments, with little or no money down.

The House and Senate reports identified three principal objections to sale and lease-back arrangements. First, the tax-exempt organization was trading on its exemption because the only contribution it made to the sale and lease-back was its tax exemption. Second, the lease-back transactions, if unchecked, would result in tax-exempt entities owning the bulk of the commercial and industrial real estate in the country. Third, the exempt organization that entered into the sale and lease-back and either paid an above-market price for the property, or charged below-market rent for the use of the property, had in effect sold part of its tax exemption. In response to these objections, Congress imposed the UBIT on income from the long-term rental of debt-financed real property and personal property leased in connection with it.

Notwithstanding the changes made by the Revenue Act of 1950, many tax-exempt organizations continued to engage in unrelated commercial activities. Such activities were permissible under the law because, first, a number of tax-exempt organizations such as churches, social clubs, and fraternal beneficiary societies were not subject to the tax on unrelated business income and, second, because the tax on rental income from debt-financed real property did not apply to leases of five years or less. The tax on debt-financed real property was avoided by so-called Clay Brown transactions -- "bootstrap acquisitions" similar to the sale and lease-back transactions described earlier.[3]

In response to the continued involvement of charitable organizations in unrelated businesses, Congress in 1969 revisited this area of the law and made several significant changes. First, the rules regarding debt-financed property were expanded to include all debt-financed property unrelated to the exempt purpose of the organization, with no exception for short-term leases. Second, the tax on unrelated business income was expanded to apply to all exempt organizations, except certain U.S. instrumentalities created and expressly granted tax-exemption by a specific act of Congress. Third, the investment income of social clubs and voluntary employees' beneficiary associations was subjected to tax, based on the rationale that an exemption for investment income constituted an unwarranted subsidy of recreational or personal activities. Fourth, any rent, interest or royalties paid by an 80-percent controlled subsidiary to a tax-exempt parent was included in unrelated business taxable income of the parent in an amount reflecting the portion of the subsidiary's income that would be unrelated business income if earned directly by the tax-exempt parent organization. The controlled subsidiary rule was imposed to discourage charitable organizations from "renting" part of their physical plants to taxable subsidiaries, thereby reducing or eliminating the taxable income of the subsidiaries. And fifth, Congress clarified the definition of the term "trade or business" to include activities carried on within a larger aggregate of similar activities. Thus, the sale of advertising in a magazine published by an exempt organization could be treated as an unrelated business, even though publication of the magazine was the organization's exempt function.

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[3] The transactions were named after the Supreme Court case that refused to recharacterize the transaction at issue and upheld the taxpayer's claimed tax benefits. Clay Brown v. U.S., 380 U.S. 563 (1965).

Each of the changes made by the Tax Reform Act of 1969 had the effect of tightening the rules with respect to the unrelated business activities of charitable organizations, helping to ensure that such organizations paid tax on income from business activities unrelated to the purpose for which they were granted tax exemption.

During the early 1980s, a number of charitable organizations again became involved in leasing transactions with taxable entities, although with a different twist from the sale and lease-back transactions described earlier. Due to the investment tax credit and accelerated depreciation, certain types of property were effectively subject to a negative rate of tax, generating credits or losses that would offset income from the other investments. Because tax-exempt organizations could not benefit from these tax incentives directly, a number of exempt organizations, including schools, city governments, federal agencies, and foreign governments, sold part of their assets to taxable businesses that could make use of the tax incentives and would then lease the property back on a long-term basis. As part of the Tax Reform Act of 1984, Congress sought to discourage such transactions by providing that property used by a tax-exempt entity (including foreign and domestic governments) is not eligible for tax incentives such as the investment tax credit and accelerated depreciation.

Subsequent to the 1969 Act, exceptions were created to the debt-financed property rule for certain real estate investments. In 1980, with respect to pension trusts, in 1984 with respect to educational institutions, and in 1986 with respect to real property title holding companies, the general rule was modified to exclude from the debt-financed property rules the acquisition of real estate with debt so long as certain requirements were met.

B. Structure of the Unrelated Business Income Tax

In general, the UBIT is imposed on the unrelated business taxable income of organizations that are otherwise exempt from tax under Code section 501(a). Tax-exempt trusts are taxed at individual tax rates and all other exempt organizations are taxed at corporate rates.

The term "unrelated trade or business" means any trade or business that is regularly carried on and is not substantially related, aside from the need of the organization for funds, to the performance of the purpose for which the organization was granted exempt status.

Specifically excluded from the term "unrelated trade or business" is any trade or business (1) in which substantially all the work is performed by volunteers; (2) which is carried on by a section 501(c)(3) organization or a state or city college or university primarily for the convenience of its members, students, patients, officers, or employees (the "convenience exception"); or (3) which is the selling of donated merchandise. Certain trade show and similar activities are also specifically excluded, as are services furnished by certain cooperative hospital service organizations, the rental of telephone poles by cooperative telephone or electric companies, the rental of mailing lists to certain other exempt organizations, and the distribution of low-cost articles incidental to soliciting charitable contributions. Conducting bingo games is also specifically excluded so long as bingo is legal under state law and is not ordinarily conducted on a commercial basis.

The term "unrelated business taxable income" is defined as the gross income derived from any unrelated trade or business less deductions directly connected with the carrying on of such trade or business, subject to certain modifications. Among the most significant of the modifications are the following:

1. All dividends, interest, payments with respect to loans of securities, and annuities are excluded.

2. Royalties (including overriding royalties), whether measured by production or by gross or taxable income, are excluded.

3. Rent from real property, and rents from personal property leased with real property if the rents attributable to the personal property are only an incidental amount of the total rents received or accrued under the lease, are excluded. If more than 50 percent of the rent under a lease is attributable to personal property, then none of the rent, whether attributable to the real property or the personal property, qualifies for the exclusion. In addition, rent does not qualify for the exclusion if the determination of the amount of such rent depends in whole or in part on the income or profits derived by any person from the property leased (other than an amount based on a fixed percentage of receipts or sales).

4. All gains or losses from the sale, exchange or other disposition of property, other than the sale of property of a kind properly includable in inventory and property held primarily for sale to customers in the ordinary course of a trade or business, are excluded. Thus, for

example, gain on commodity futures contracts ordinarily would be excluded. Also excluded are all gains on the lapse or termination of options to buy or sell securities written by the organization in connection with its investment activities.

5. Income from various research activities also is excluded. All income from research performed for the United States, a state, or a political subdivision of a state is excluded. In the case of a college, university, hospital, or organization operating primarily for the purpose of carrying on fundamental research that makes the results of its research freely available to the public, all income derived from research is excluded, regardless of for whom it is performed.

6. A "specific deduction" of $1,000 is allowed from unrelated business taxable income for all tax-exempt organizations, thus preventing the imposition of tax when the profit from an unrelated business activity is very small.

As noted earlier, the modifications for interest, royalties, annuities and rents do not apply to an 80-percent controlled subsidiary to the extent it is engaged in a trade or business unrelated to the exempt purpose of the parent organization.

Special rules apply in computing the unrelated business taxable income of social clubs, voluntary employees' beneficiary associations, supplemental unemployment benefit trusts and group legal services organizations. In general, all income of these organizations other than "exempt function income" is deemed to be unrelated. Exempt function income is income from dues, fees, charges, or similar amounts paid by members of the organization as consideration for providing such members (or their dependents or guests) goods, facilities or services in furtherance of the organization's exempt purpose, and income set aside for charitable purposes or for certain defined benefits. In the case of voluntary employees' beneficiary associations, supplemental unemployment benefit trusts, and group legal services organizations, there are in addition various limits on the extent to which such set aside income is treated as exempt function income. The primary effect of these rules is to tax the investment income of the organizations subject to the rules.

The provisions of section 514, pertaining to "unrelated debt-financed income," also represent a set of special rules in that a charitable organization can have unrelated business taxable income under this section regardless of whether it is engaged in a trade or business. The section provides that to the extent any property held for the production of income is debt-financed, the income from the property is subject to tax.

There are a number of exclusions from the definition of debt-financed property, including the following: (1) property the use of which is substantially related to the exempt purpose of the organization, (2) property used for research activities, the income from which is specifically excluded from tax under section 512, and (3) property used in certain other trades or businesses, the income from which is excluded under section 513, namely, businesses run by volunteers, businesses run for the convenience of members, students, etc., and businesses involving the sale of donated property.

A final, and very significant, exception to the debt-financed income rules is an exception, added in 1980 and subsequently amended, for the acquisition of real estate by "qualified organizations," namely, educational institutions, pension trusts, and real property title holding companies exempt under section 501(c)(25). Section 514(c)(9) provides that the term "acquisition indebtedness" does not include debt incurred by a qualified organization to purchase real property so long as certain conditions are met. These conditions include: (1) the purchase price is a fixed amount; (2) the amount of any indebtedness, and the time for payment of such indebtedness, is not contingent on revenue, income, or profits derived from the real property; (3) the real property is not leased back to the seller or a party related to the seller; (4) the real property, if purchased by a pension trust, is neither purchased from, nor leased to, certain disqualified persons; (5) neither the seller nor a related party or certain disqualified persons (in the case of a pension trust) provides financing in connection with the real property; and (6) if the real property is held by a partnership and one or more of the partners is not a qualified organization, then allocations to the partners must be "qualified allocations" (i.e., must not vary over time) or must follow a special rule allowing certain variations from qualified allocations. The elaborate requirements of section 514(c)(9) were designed, in part, to prevent charitable organizations from entering into the type of "bootstrap" acquisitions that were common prior to the Tax Reform Act of 1969.

III. Tax Policy Considerations

A. Rationale for Tax Exemption of Nonprofit Organizations

The exemption of charitable, religious, and educational organizations from tax has been a part of federal law since 1894 when the first federal act imposing a general tax on the income and profits of corporations was enacted. Many other tax exemption provisions, including those for labor unions, trade associations, and social clubs, were enacted over seventy years ago. Despite, or perhaps because of, the long history of tax exemptions in the federal income tax law, there is little guidance in the legislative record as to the rationale for exempting particular organizations from tax. At the time of the early income tax statutes, however, most exempt organizations were supported primarily by donations. Notions of taxable income were not easily applicable to their activities, distinguishing them from the for-profit businesses that Congress intended to tax. Certain other organizations, such as labor unions or trade associations, were (and continue to be) funded principally by membership dues and could appropriately have been viewed as mutual benefit organizations that function, in part, as conduits for their members.

Over the years, the exempt sector has grown enormously in both size and diversity. Moreover, many exempt organizations have come gradually to derive much or all of their income from sources other than donations. These changes have not only increased the importance of tax exemption to the exempt sector, but have also tended to blur the historical differences in activities and funding between exempt and taxable organizations. The broadest segment of the exempt sector, for example, including in particular those organizations exempt under section 501(c)(3) engaged in educational and health activities, draw substantial revenues from sources that could, at least in concept, be subject to income tax. Tax exemption for these organizations may, in part, reflect historical circumstances, but is more importantly based on the same tax policy principles that support an income tax deduction for charitable contributions. Taxes are imposed to fund the activities of government, and represent a removal of resources from private hands to support the broad, public purposes served by government. Although public charities are privately operated and controlled, their exempt activities are restricted to those deemed to serve the general public interest. An organization that provides food and shelter for the poor, or that encourages education, the arts or humanities, is serving the same general purposes with which government itself is concerned. Thus, resources dedicated to the activities of such organizations may be viewed as similar to funds transferred to and used for the general purposes of government. For this reason, income transferred through a charitable contribution or earned directly by a public charity may appropriately be exempted from tax.

Although the above rationale for exempting public charities and their activities from taxation remains as strong today as when the income tax was first enacted, limits on the scope of such tax exemption are appropriate and necessary. This nation has prospered through its reliance on a private, market-based economy to supply necessary goods and services. The role of government generally has been restricted to those socially important activities not adequately supported by the private sector. The role of the quasi-governmental, not-for-profit sector should similarly be restricted to that of supplementing, and not supplanting, the activities of for-profit businesses. Thus, tax exemption for public charities should be restricted to those areas where the quality or quantity of goods and services that would be produced strictly through market forces is inadequate, or the distribution of those goods or services undesirable.

B. The Problem of Competition

As described above, Congress adopted the unrelated business income tax primarily because of its concern with "unfair" competition between tax-exempt organizations and taxable businesses. Some competition between tax-exempt and taxable activities is inevitable, however, and could not be eliminated without repealing altogether the tax exemption for many nonprofit organizations. A nonprofit hospital will compete with for-profit hospitals for patients, and, in providing its patients with food, drugs or medical devices, will compete with taxable businesses offering the same products. Similarly, in maintaining student dormitories and dining halls, an exempt university will compete with local businesses offering housing and meals. Because the hospital and university are not subject to tax, they may be able to provide goods or services at a lower cost than their taxable competitors or to expand more rapidly to attract additional students or patients. Although this may leave the exempt organization with a competitive advantage over its taxable counterpart, this advantage is an intended consequence of the societal decision to encourage the exempt functions performed by these organizations.

Competition between taxable and tax-exempt organizations becomes of greater concern, however when the good or service provided by the tax-exempt organization is further removed from the organization's core purposes. We may not be concerned that a state university's tax exemption extends to sales of textbooks through the student bookstore, since the product is essential to the school's educational function and may be irregularly or incompletely supplied by private businesses. If the same student bookstore, however, also sells clothes, appliances and other consumer goods, the activity moves further from the university's educational function, and involves products which in general are amply supplied by the private sector. Extending the university's tax exemption to sales of these products may only displace taxable businesses in an area where private markets are working effectively.

There is little empirical evidence regarding either the behavior of exempt organizations in competition with taxable businesses or the response of taxable businesses to such competition. Even though tax exemption allows a nonprofit organization to earn a higher rate of return than a taxable company within a particular activity, some have argued that this does not necessarily create an adverse effect on the taxable business. Because the nonprofit organization enjoys a similarly higher rate of return on other uses of its capital, including passive investments, the relative "opportunity cost" of entering a particular business (which includes the revenue lost from forgoing alternative investments) can be equivalent for taxable and exempt organizations. As a result, taxable and exempt businesses may be in the same relative position with respect to the decision whether or not to enter a particular business. Thus, following this analysis, if income tax exemption were the sole benefit granted to nonprofit organizations, nonprofit and taxable organizations might well co-exist in the same business, just as such organizations co-exist in the stock and bond markets.

Nonetheless, when tax exemption is combined with other governmental subsidies -- such as the ability of some exempt organizations to issue tax-exempt bonds, access to lower postal rates, exemption from certain federal excise taxes, and exemption from certain state and local taxes -- an exempt organization's cost of producing goods and services for sale is further reduced. Hence, its profit is increased without a corresponding increase in the return available from alternative passive investments. Consequently, there exists an additional incentive to produce such goods or services as opposed to making a passive investment.

In addition, as a result of their various cost-saving benefits, it is possible that tax-exempt organizations would reduce their prices in an attempt to drive out non-exempt competitors. Engaging in this type of "predatory" pricing leads firms to forego profits in the short run, in the hope that future profits will be large enough to overcome the near-term losses. There is little agreement, however, among economists about whether such pricing is common or whether it is likely to be successful. A further complicating factor with respect to the pricing behavior of exempt organizations is that they will often be motivated primarily by the desire to maximize the output of their exempt product, not by the desire to maximize profits. This could result in prices of such exempt products that are lower than the prices of the goods and services sold by taxable competitors and that give rise to no taxable income. Although a taxable competitor might well view this as predatory pricing, the tax-exempt organization might in fact have no desire to ultimately raise its prices to capture a monopoly profit. The desire to maximize exempt output would depend, of course, on whether the organization views those items as part of its primary exempt function, rather than as part of an ancillary, profit-seeking function.

Thus, although the precise consequences are not perfectly understood, the combination of tax exemption with other governmental subsidies will in some cases create a competitive advantage for tax-exempt organizations. Such advantage could be sufficient in certain cases to discourage taxable firms from entering an industry or could encourage existing taxable firms to leave the industry. This result is of particular concern if exempt organizations impinge on activities previously carried on principally by taxable businesses. In such a situation, the taxable businesses would not have anticipated competition from tax-exempt organizations and would have made economic decisions ignoring this possibility.

C. Economic Efficiency

In addition to limiting unfair competition, the unrelated business income tax serves the goal of economic efficiency by helping to ensure that the subsidy of tax exemption is used in the manner that provides the greatest social benefit.

The effect of the UBIT on economic efficiency can best be seen by considering the impact of a system that exempts from tax all unrelated business income. Such a tax system would encourage equally the pursuit of exempt and unrelated activities by non-profit organizations. This would be an inefficient use of the grant of tax exemption, in that a subsidy is not needed to assure production of appropriate amounts of most commercial goods and services.

Tax exemption for unrelated business income would also act as an indirect subsidy to the primary exempt function of a nonprofit organization because the organization would direct some or all of its unrelated business income towards its exempt function. Subsidizing the primary exempt function of nonprofit organizations by means of a tax exemption for unrelated income, however, would simply reward those organizations that are most successful in pursuing commercial ventures. Such a system would be unlikely to provide the greatest reward to the most deserving organizations; i.e., those that provide the greatest social benefit.

Our current tax system does not, of course, exempt all nonprofit income from taxation. Nevertheless, the criterion of economic efficiency can be applied to those particular areas in which nonprofit commercial activities do, in fact, escape taxation in order to help determine whether such activities should remain exempt.

D. Accountability

As indicated above, the privilege of tax-exempt status affords substantial benefits and, at least with respect to public charities, may be justified because of the public, quasi-governmental purposes served by their activities. Because nonprofit organizations are privately controlled, however, their activities are not subject to the public review or scrutiny that applies to the actions of government. It is thus necessary that the tax system ensure that nonprofit organizations are operated for the purposes that support their exemption.

At present, the responsibility for ensuring that nonprofit organizations are accountable for the benefits of tax exemption rests in large part on the enforcement activities of the Internal Revenue Service. Through the return and audit process, the Internal Revenue Service is in a position to review the activities of nonprofit organizations and the purposes for which their funds are spent.

In addition to focusing on an exempt organization's use of funds, however, the tax system may improve accountability by encouraging particular sources of funding. Thus, rules limiting the scope of tax exemption may appropriately encourage an exempt organization to concentrate on activities and investments that do not distract from its exempt function. This chanelling function may be served by the current law rules subjecting nonprofit organizations to tax on their unrelated business activities. Although the earnings from an unrelated business activity may go equally to serve the organization's exempt purposes, the unrelated activity may divert management resources or otherwise cause the organization to lose sight of its exempt function. In the same vein, the current law rules exempting passive investment income, whether or not related to a nonprofit organization's exempt function, effectively encourage investments that will not directly engage the organization in purely commercial activity.

There are, of course, limits on the extent to which the tax laws can be used to ensure accountability of tax-exempt organizations. For example, the role of determining whether contributed funds are used wisely and efficiently is not a function of the tax law, but is performed to some degree by donors who support exempt organizations. If an organization is able to sustain itself to an increasing extent by commercial activity, however, it becomes less dependent on the scrutiny of such private donors. Hence the UBIT helps ensure that exempt organizations remain, at least to some degree, accountable to third-party donors. The ability of donors to perform this oversight function would also be aided by fuller public disclosure required by federal or state law.

IV. Analysis of Current Law

In our testimony before the Oversight Subcommittee on June 22, 1987, we described a number of aspects of the UBIT as warranting Congressional attention. Our recommendations, in summary, were as follows:

1. With respect to business activities of exempt organizations, the Treasury Department believes the current standard of a substantial relationship to an organization's exempt purpose has conceptual merit as the basis for granting exemption from tax. We are concerned, however, with administrative and interpretative problems this standard has created. Although we do not propose changes in the "substantially related" standard, we do recommend more detailed reporting as a means of improving enforcement and compliance and of providing a basis for further review of the adequacy of the standard.

2. With respect to the existing exceptions from the "substantially related" standard, we suggest that the scope of the exemptions for businesses operated by volunteers or for the convenience of students, patients

and others should be reexamined. We are concerned that these provisions may extend to activities not meriting exemption and, at least in their current form, cannot be justified on grounds of administrative convenience. Although similar conceptual questions might be raised about the provision exempting sales of donated property, in practice, we believe the exception operates appropriately.

3. With respect to the computation of the tax on unrelated business income, we suggest that the rules for allocation of expenses be clarified to reflect the appropriate relationship between an organization's exempt functions and unrelated activities. In addition, we support retention of the "fragmentation rule" and an increase in the specific deduction from unrelated business income from $1,000 to $5,000.

4. For purposes of characterizing otherwise tax-exempt passive income from subsidiaries as taxable, we suggest that the definition of a controlled subsidiary be broadened to include subsidiaries in which an exempt organization has more than a 50 percent interest in stock value or voting power. In addition, for purposes of determining whether the primary purpose of an organization is the conduct of an exempt function, we suggest that consideration be given to aggregating the activities of an exempt organization and its subsidiaries in appropriate cases.

5. With respect to passive investment income, we suggest that such income should continue to be exempt in the case of public charities, but should be taxable to social welfare organizations unless permanently set aside for charitable purposes. The treatment of passive income of labor unions and trade associations requires further study. In addition, we suggest that the exclusion for royalties should be narrowed to prevent avoidance of the tax on unrelated business income in certain circumstances.

6. With respect to the exclusions from tax for income derived from certain research activities, we believe additional attention should be given to the definition of research and to requirements for public dissemination of the results of research.

7. With respect to joint venture activities of exempt organizations, we are concerned that current restrictions on partnership allocations between taxable and tax-exempt partners may not be adequate to prevent abuse. In addition, we have serious reservations whether current law is adequate to deal with issues raised by partnerships formed to conduct exempt activities of tax-exempt organizations.

In our testimony before the Oversight Subcommittee on May 9, 1988, we commented on a group of "discussion options" released by the Subcommittee. We testified in support of a number of these discussion options, some with certain modifications. In general, the discussion options we supported would:

1. Retain the "substantially related" standard.

2. Provide special rules that override the "substantially related" standard in several particular areas, providing instead a "bright line" test for taxability. These areas include: retail stores, medical equipment sales, fitness facilities, travel and tour services, some food sales, veterinary services, hotels, routine testing, affinity credit cards, advertising, and amusement parks.

3. Repeal the convenience exception.

4. Modify the taxation of royalties in order to distinguish active from passive royalties.

5. Increase the specific deduction to $5,000.

6. Modify the definition of a "controlled subsidiary" and the rules applicable to such subsidiaries.

7. Aggregate the activities of exempt organizations and certain controlled subsidiaries for purposes of applying the primary purpose test.

8. Revise the rules for allocating expenses between exempt and taxable uses of property.

9. Expand reporting to the IRS and mandate certain studies.

In addition to supporting these relatively discrete changes to the UBIT being considered by the Oversight Subcommittee, the Treasury Department believes that Congress should undertake a broad review of the rationale for tax exemption in order to ensure that the substantial benefits of tax exemption are appropriately limited. Such a review would enable Congress to determine whether the current categories of exempt organizations, and the basic rules regarding unrelated business taxable income, are appropriate when applied to the tax-exempt sector of our modern economy -- a sector that is undeniably much changed since the earliest rules regarding tax exemption were adopted by Congress. This kind of comprehensive review would require the collection of improved data regarding the scope of commercial activities being conducted by exempt organizations and the effect of those activities on taxable competitors. Hence Treasury believes that a Congressional mandate to expand the reporting requirements of exempt organizations, with appropriate exceptions for small organizations, is particularly important.

V. Other Options for Addressing Issue of Unfair Competition.

The debate during recent years with respect to competition between taxable businesses and tax-exempt organizations has focused on the grant of federal income tax exemption and the operation of the unrelated business income tax. Although these are important issues and warrant careful consideration by Congress, tax exemption is only one component of the overall governmental effort to encourage and subsidize the activities of certain non-profit organizations. Much work remains to be done in analyzing these additional subsidies and helping to coordinate the efforts of the federal government, together with state and local governments, to provide incentives in the most economically efficient and equitable manner. Such incentives should be designed to encourage the increased production of undersupplied goods and services by the tax-exempt sector while at the same time not discouraging the taxable sector from providing these same goods and services.

We believe the Committee on Small Business has an important role in the analysis and resolution of the issues noted above. In particular, we recommend that the Committee consider undertaking the following three initiatives.

1. Coordination of federal, state and local actions.

The question of the appropriate scope of tax exemption and other governmental subsidies has been sporadically reviewed at the federal, state and local levels. Several localities, for example, have recently challenged the real estate tax exemption of non-profit hospitals. It would be helpful if a more coordinated review were undertaken. In particular, it would be useful to know where and how state criteria for exemption have come to differ from federal criteria and why. As a first step, an effort should be made to quantify, in a systematic manner, the types and amounts of governmental subsidies provided to various categories of tax-exempt organizations. For example, it would be useful to know which organizations that are exempt from federal income tax are also exempt from local real estate tax. A second step would be to analyze whether those subsidies are being allocated in an economically efficient manner -- i.e., whether those organizations providing the greatest social benefit also receive the largest subsidies.

2. Further analysis of "unfair competition".

As noted above, there is little conclusive evidence regarding the competitive effects of tax exemption and other governmental subsidies. This issue should be studied in greater detail, utilizing improved data that the Internal Revenue Service intends to collect as well as data collected by other governmental agencies and private organizations. It would be helpful, for example, to analyze particular industries in which the balance between taxable and exempt firms has changed over time. More generally, it would be useful for research to address basic questions regarding the behavior of non-profit organizations to determine, for example, whether they are likely to engage in predatory pricing and whether they tend to produce higher or lower quality output vis a vis taxable competitors. Because current policy analysis is based largely on anecdotal evidence, it is difficult to reach broad conclusions with respect to these important issues.

In addition, it would be beneficial to undertake a broad analysis of the interrelatedness of exempt organizations and taxable businesses; in particular, whether exempt organization activities may in some cases assist the growth of taxable businesses. For the most part, representatives of particular businesses (such as travel agencies or fitness clubs) have raised concerns about exempt organizations that directly compete in those businesses. Although such concerns are entirely appropriate, these businesses may not have considered whether the presence of exempt organizations may at times encourage other kinds of taxable businesses. A number of exempt organizations have asserted, for example, that their income-producing activities often create substantial opportunities for taxable businesses. Examples cited have included universities producing new technology that is developed by the taxable sector or organizations whose activities draw tourists to a particular area and thus create opportunities for restaurants, hotels, etc. To the extent that these increased opportunities represent new economic activity, rather than simply replacement of such activity elsewhere, they provide economic benefits to all.

3. Improved cooperation between taxable and exempt entities.

In many instances the problem of unfair competition could be reduced by increased cooperation between taxable and exempt competitors. Tax-exempt organizations generally do not have an interest in developing and managing active businesses and thus drawing attention away from their charitable, educational, etc. pursuits. Concerns with funding for their exempt functions will often mandate that an organization vigorously pursue every revenue source, however, and exempt organizations should not be expected to allow facilities or assets capable of producing income to lie idle. Instead, taxable businesses should be encouraged to work with exempt organizations in order to bring these available facilities and other assets into the marketplace in a manner that maximizes passive income for the exempt organization and active business income for the taxable company. We believe this Committee is well situated to encourage this form of mutually beneficial cooperation.

The Committee on Small Business serves an invaluable function in providing a forum for the concerns of small businesses. Such concerns are of the utmost importance to those of us involved in the formulation and administration of the unrelated business income tax. We welcome your assistance in identifying problems and formulating solutions in this important and difficult area.

This concludes my prepared remarks. I would be pleased to respond to your questions.

Figure 1. -Description, General Nature of Activities, Example, and Number of Tax-Exempt Organizations, By Internal Revenue Code Section

Section of IRC	Description of Organizations	General Nature of Activities	Example of Organizations	Number of Organizations
501(c)(1)*	Corporations organized under Act of Congress (including Federal Credit Unions)	Instrumentalities of the United States.	Federal Deposit Insurance Corp.	24
501(c)(2)	Title holding corporation for exempt organization	Holding title to property of an exempt organization.	Naugatuck Masonic Building Corp.	5,712
501(c)(3)*	Religious, educational, charitable, scientific, literary. Testing for public safety, fostering certain national or international amateur sports competitions, or prevention of cruelty to children or animals organizations. Includes private foundations and nonexempt charitable trusts.	Activities of nature implied by description of class or organization.	American Heart Association, Inc., Ford Foundation	386,987
501(c)(4)	Civil leagues, social welfare organizations, and local associations of employees	Promotion of community welfare, charitable, educational, or recreational.	Lions Clubs	129,423
501(c)(5)	Labor, agricultural, and horticultural organizations	To improve conditions of work and to improve products and efficiency.	AFL-CIO	71,182
501(c)(6)	Business leagues, chambers of commerce, real estate boards, etc.	Improvement of business conditions of one or more lines of business.	Chamber of Commerce National Football League	56,336
501(c)(7)	Social and recreational clubs	Pleasure, recreation, social activities.	Ocean Ski Club, Inc.	56,216
501(c)(8)	Fraternal beneficiary societies and associations	Lodge providing for payment of life, sickness, accident, or other benefits to members.	Knights of Columbus	86,255

Figure 1--Continued

Section of IRC	Description of Organizations	General Nature of Activities	Example of Organizations	Number of Organizations
501(c)(9)	Voluntary employees' beneficiary associations (including federal employees' voluntary beneficiary associations formerly covered by section 501(c)(10))	Providing for payment of life, sickness, accident, or other benefits to members.	Warren Firefighers Fund Assoc.	10,481
501(c)(10)	Domestic fraternal societies and associations	Lodge devoting its net earnings to charitable, fraternal, and other specified purposes. No life, sickness, or accident benefits to members.	Knights Templar of the US 33 Natick Commandery	16,953
501(c)(11)	Teachers' retirement fund associations	Teachers' association for payment of retirement benefits.		9
501(c)(12)	Benevolent life insurance associations, mutual ditch or irrigation companies, mutual or cooperative telephone companies, etc.	Activities of a nature similar to those implied by the descriptions of class of organization beneficial to members.	Salem Rural Water Corp.	5,145
501(c)(13)*	Cemetery companies	Burials and incidential activities for members.	Williamson Cemetery Assoc.	7,704
501(c)(14)	State chartered credit unions, mutual reserve funds	Loans to members. (Exemption for building and loan associations and cooperative banks repealed by Revenue Act of 1951, affecting all years after 1951).	Williamson County Catholic Credit Union	6,189
501(c)(15)	Mutual insurance companies or associations	Providing insurance to members substantially at cost (limited to organizations with gross income of $150,000 or less).	Sand-Clay Mutual Burial Assoc.	910

Figure 1--Continued

Section of IRC	Description of Organizations	General Nature of Activities	Example of Organizations	Number of Organizations
501(c)(16)	Cooperative organizations to finance crop operations	Financing crop operations in conjunction with activities of a marketing or purchasing association.		18
501(c)(17)	Supplemental unemployment benefit trust	Payment of supplemental unemployment compensation benefits.	Dayton Malleable Iron Company, Ohio Malleable Div.	702
501(c)(18)	Employee funded pension trust	Payment of benefits under a pension plan funded by employees (created before June 25, 1959).		5
501(c)(19)*	Post or organization of war veterans	Activities implied by nature of organization.	American Legion Posts	24,015
501(c)(20)	Trusts for prepaid group legal services	Forms part of a qualified group legal service plan or plans. (Applicable to taxable years beginning after December 31, 1976).		202
501(c)(21)	Black Lung Trusts	Satisfies claims for compensation under Black Lung Acts. (Generally, applicable to taxable years beginning after December 31, 1977).		21
501(c)(22)	Pension Trust	Pension plan withdrawal liability trust created to provide funds to meet payments under section 4223(i) or (j) of ERISA.		0
501(c)(23)	Veterans' insurance associations	Provide insurance and other benefits to member veterans.		0
501(c)(24)	Trusts	Described in ERISA section 4049		0
501(c)(25)	Title holding companies	Those with 35 or fewer entities exempt under IRC section 401 and 501(c)(1) and governmental units.		0

Figure 1--Continued

Section of IRC	Description of Organizations	General Nature of Activities	Example of Organizations	Number of Organizations
501(d)	Religious and apostolic associations	Regular business activities; communal religious community.		84
501(e)*	Cooperative hospital service organizations	Enumerated cooperative services for hospitals.		79
501(f)*	Cooperative service organizations of operating educational organizations	Collective investment services for educational organizations.		1
			TOTAL	865,653

* Generally, contributions under this Code subsection are tax deductible. Other organizations not asterisked could establish trusts under Code subsection 501(c)(3) which may receive tax deductible contributions.

NOTE: Examples are not shown for organizations tax-exempt under Code subsections 501(c)(11), (16), (18), (20), (21), 501(d), 501(e), and 501(f) because there is very little activity.

NOTE: Number of organizations is a count of the number of active entities on the IRS Exempt Organization/Business Master File as of April 30, 1987.

Table 1

Sources of Nonprofit Support by Subsector, 1984

Type of Nonprofit Organization	Total Revenues	Private Contributions 1/	Government	Dues, Fees & Charges	Endowment & Other
Health					
$ billion	$125.7	$17.4	$44.5	$60.8	$3.0
percent	100%	13.8%	35.4%	48.4%	2.4%
Education & Research					
$ billion	$57.1	$11.8	$9.7	$30.5	$5.0
percent	100%	20.7%	17.0%	53.4%	8.8%
Religious Organizations					
$ billion	$28.8	$24.8	–	–	$4.0
percent	100%	86.1%	0%	0%	13.9%
Social Service 2/					
$ billion	$21.8	$8.3	$9.6	$2.8	$1.1
percent	100%	38.1%	44.0%	12.8%	5.0%
Civic, Social and Fraternal					
$ billion	$7.0	$2.2	$3.5	$0.9	$0.4
percent	100%	$31.4%	50.0%	12.9%	5.7%
Arts and Culture					
$ billion	$6.9	$4.6	$0.9	$0.7	$0.7
percent	100%	66.7%	13.0%	10.1%	10.1%

Department of the Treasury
Office of Tax Analysis

June 19, 1987

Source: Dimensions of the Independent Sector, 1986, Table 4.1.

1/ Including contributions from churches.
2/ Including legal services.

Note: Foundations are excluded.

Note: Detail may not add to totals due to rounding.

Table 2

Nonprofit Charitable Organizations

Components of Revenue as Percent of Total Revenue by Asset Size, 1983

Asset Size	Private Contributions	Government Grants	Dues & Assessments	Program Service Revenue	Other
Under $100,000	23.2	42.8	6.4	20.6	7.0
$100,000--$499,999	18.7	34.4	5.2	34.3	7.4
$500,000--$999,999	22.8	40.8	2.0	26.7	7.7
$1,000,000--$9,999,999	17.0	13.2	2.0	55.4	12.4
$10,000,000--$49,999,999	11.0	4.5	1.2	72.9	10.4
$50,000,000 or More	6.5	5.9	0.7	73.0	13.9

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Competition Between Tax-Exempt Organizations and Taxable Businesses

Statement of
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General Government Division

Before the
House Committee on Small Business

COMPETITION BETWEEN TAX-EXEMPT ORGANIZATIONS AND TAXABLE BUSINESSES

Summary Statement of
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U.S. General Accounting Offices

Competition has become a major concern to both the taxable business and tax-exempt communities because they are increasingly providing similar services. Tax-exempt organizations are becoming more involved in activities traditionally done by taxable businesses, such as publishing services and tours. On the other hand, tax-exempt organizations see taxable businesses as becoming more involved in activities traditionally dominated by tax-exempt organizations, such as day care and physical fitness.

Complete data do not exist to quantify the exact nature, extent and impact of competition between the tax-exempt and taxable business communities. The tax-exempt community has grown significantly over the years in terms of numbers of organizations and types of activities. It also appears that tax-exempt organizations have become more reliant on income-producing activities and less reliant on charitable and government sources of revenue to fund their activities. The tax-exempt community has attributed this shift in funding sources, in part, to a reduction in government support and the inability of other traditional funding sources, such as contributions, to compensate for this reduction. These income-producing activities may result in competition with taxable businesses. However, because of the lack of data, it is difficult to measure the impact of competition on the business sector.

The business community is voicing increased concern about competition from tax-exempt organizations' income-producing activities. Although some representatives of tax-exempt organizations believe that income-producing activities further their exempt purposes, some representatives of taxable businesses view these activities as exceeding the traditional role of these organizations. Business representatives also view these organizations as having a competitive advantage by virtue of their tax-exempt status and other benefits. Our 1986 survey of businesses in six industries -- audio-visual, racquet sports, research and testing, tour, travel, and veterinarian -- revealed that a substantial number of the businesses reported experiencing competition from one or more tax-exempt competitors. However, the specific types of competitors and the extent and effects of competition that were reported varied from industry to industry.

Mr. Chairman and Members of the Committee:

We are pleased to be here today to assist the Committee in its inquiry into the issue of competition between tax-exempt organizations and taxable businesses. Our statement is based primarily on a 1987 report we issued to the Joint Committee on Taxation on the issue of competition between taxable businesses and tax-exempt organizations (GAO/GGD-87-40BR). This report showed that competition has become a major concern to both the taxable business and tax-exempt communities because they are increasingly providing similar services. Tax-exempt organizations are becoming more involved in activities traditionally done by taxable businesses, such as publishing services and tours. On the other hand, tax-exempt organizations see taxable businesses as becoming more involved in activities traditionally dominated by tax-exempt organizations, such as day care and physical fitness.

I would like to highlight two major points about the competition issue.

First, complete data do not exist to quantify the exact nature, extent and impact of competition between the tax-exempt and taxable business communities. The tax-exempt community has grown significantly over the years in terms of numbers of organizations and types of activities. It also appears that tax-exempt organizations have become more reliant on income-producing activities and less reliant on charitable and government sources of revenue to fund their activities. These income-producing activities may result in competition with taxable businesses. However, because of the lack of data, it is difficult to measure the impact of competition on the business sector.

Second, the business community is voicing increased concern about competition from tax-exempt organizations' income-producing activities. Although some representatives of tax-exempt organizations believe that income-producing activities further their exempt purposes, representatives of taxable businesses view these activities as exceeding the traditional role of these organizations. Business representatives also view these organizations as having a competitive advantage by virtue of their tax-exempt status and other benefits. Our survey of businesses in six industries -- audio-visual, racquet sports, research and testing, tour, travel, and veterinarian -- revealed that a substantial number of the businesses reported experiencing competition from one or more tax-exempt competitors. However, the specific types of competitors and the extent and effects of competition that were reported seemed to vary from industry to industry.

I would now like to discuss these points in more detail.

LIMITED DATA EXIST ON THE COMPETITION ISSUE

Although there are data bases on segments of the tax-exempt community, such as hospitals and colleges, data on the overall community are limited, especially with regard to its involvement in income-producing activities and competition with taxable businesses. IRS routinely collects tax return and other data on tax-exempt organizations and is generally regarded as having the best data available on these organizations. However, these data do not encompass the entire tax-exempt community. For example, IRS does not compile information on churches because they are not required to file for tax-exempt status. In addition, the data may be unreliable because of inaccurate reporting by tax-exempt organizations when filing returns. Also, the data do not identify the type, specific nature, and extent of income-producing activity of tax-exempt organizations.

Private researchers studying the scope and nature of tax-exempt organizations have also found data sources to be limited or inadequate. For example, two nonprofit groups, the Urban Institute and the Independent Sector, made major studies of charitable and social welfare tax-exempt organizations and noted significant information gaps.

The limited data that do exist indicate that the tax-exempt community has grown significantly in terms of number of organizations and types of activities. This growth could be part of the cause of the increasing concern of the business community with regard to competition.

Internal Revenue Service statistics showed that as of September 30, 1968, there were 409,789 tax-exempt organizations on IRS's master file; as of July 31, 1987, there were 871,806, an increase of over 100 percent in about 19 years. Accompanying this growth in numbers of organizations has been an expansion of the activities in which they engage. In 1965, IRS listed 90 different tax-exempt activities; currently, IRS lists over 260 such activities. Further, many tax-exempt organizations engage in more than one activity. For example, 1985 IRS data showed 43 percent of tax-exempt organizations were doing one activity, 30 percent were doing two activities, and 27 percent were doing at least three activities. While many of these appear to be traditional charitable-type activities, such as missionary and fund-raising activities, others appear to be more similar to taxable businesses in nature. For example, some tax-exempt organizations offer publishing services and conduct travel tours.

As tax-exempt organizations have evolved over the years in terms of number and activities, many appear to have become more reliant on income-producing activities and less reliant on support from contributions, government grants, and dues. Some organizations are now imposing fees for services related to their exempt purpose which were previously provided at little or no cost, expanding services to new markets, and operating income-producing activities either related or unrelated to their exempt purpose. The tax-exempt community has attributed this shift in funding sources, in part, to a reduction in government support and the inability of other traditional funding sources, such as contributions, to compensate for this reduction.

The trend toward less reliance upon contributions and dues is particularly evident among those organizations established for charitable, religious, and educational purposes -- the section 501(c)(3) organizations. Contributions as a percent of total revenue for these organizations decreased from 36 percent of total revenue in 1946 to 18 percent in 1982. Other revenue as a percentage of total revenue increased from 59 percent to 81 percent during the same period. The other revenue category includes such items as business receipts, interest, dividends, rents, royalties, and sales of assets.

In sum, the overall statistics show that the tax-exempt community has grown significantly in terms of numbers of organizations and activities and is increasingly reliant on income-producing activities as a source of revenue. This reliance on income-producing activities has led to instances where some tax-exempt organizations are competing with taxable businesses to provide similar services. Instances of competition between tax-exempt organizations and taxable businesses have become a frequent topic of discussion within these two communities, in the media, and even in Congress. While it is no doubt true that some competition occurs, complete data do not exist to quantify the nature, extent and impact of such competition. Simply put, we do not know how much of a problem this is.

BUSINESSES VIEW COMPETITION FROM TAX-EXEMPT ORGANIZATIONS AS AN INCREASING PROBLEM

Because information on the competition issue is largely fragmented and compiled on an informal basis, we solicited the views of representatives of selected tax-exempt organizations and taxable businesses to get more perspective on the competition issue.

Not unexpectedly, tax-exempt and taxable business representatives have differing views on the issue. Tax-exempt organization representatives believe that income-producing activities further their exempt purposes and are important to generate needed additional revenue to fund their activities. Further, they believe that competition is the result of taxable businesses increasingly entering traditional tax-exempt activities, such as day care or physical fitness. Representatives of taxable businesses, on the other hand, believe that income-producing activities of tax-exempt organizations exceed the traditional role of these organizations, and that these organizations are afforded a competitive advantage by virtue of their tax-exempt status and other benefits.

In order to obtain more detailed information on the perceptions of competition by taxable businesses, in 1986 we sent a questionnaire to 1,738 randomly selected businesses in six industries -- audio-visual, racquet sports, research and testing, tour, travel, and veterinarian. We selected these industries because representatives from various businesses within these industries had written most often to the Small Business Administration voicing concern about competition. The questionnaire requested background information about the respondent's business and the respondent's perceptions of the extent, if any, of competition with tax-exempt organizations and its effects. More detailed information on our scope and methodology is contained in our 1987 report. Although perceptions on the nature and extent of competition varied by industry, some common themes also emerged.

First, a substantial number of businesses in each industry reported experiencing competition from one or more tax-exempt competitors during the period 1980 to 1985. This ranged from a low of 45 percent of travel businesses reporting competition to a high of 90 percent of racquet sports businesses reporting competition. (The attachment to this statement provides more detailed results by industry group.)

Second, a majority of those businesses that reported experiencing competition thought that it was increasing. A majority of businesses in four of the six industries thought that the actual number of tax-exempt competitors had increased, while majorities in all six industries responded that the extent of competitive activities from tax-exempt organizations had increased.

Third, the primary type of tax-exempt competitor varied by industry. Audio-visual and research and testing businesses reported the most competition from public universities. Travel and tour businesses reported the most competition from religious organizations, with public universities a close second in each case. Predictably, veterinarians reported the most competition from humane societies, and racquet sports businesses reported the most competition from YM/YWCAs.

Fourth, representatives of the taxable business community said that tax-exempt organizations have an advantage when competing with taxable businesses. These representatives cited the following as contributing to this advantage: certain exemptions from federal, state, and local taxes; the availability of grants and free facilities; reduced mailing rates; volunteer labor; and the erroneous belief of some taxpayers that amounts remitted to tax-exempt organizations for goods and services are fully deductible as charitable contributions. The extent to which these various factors are considered to contribute to an advantage varied among the six industries we surveyed. For example, our survey results show that subsidy through government grants and facilities was seen as contributing to an advantage to a moderate, great or very great extent by 89 percent of the estimated 177 research businesses who said they were experiencing competition, and 47 percent of the estimated 10,540 veterinarians who said they were experiencing competition.

Fifth, over half the taxable businesses in each of the six industries reported that the presence of tax-exempt competitors decreased profits for their businesses and reduced a current or potential market. Many businesses in each industry also cited tax-exempt competition as necessitating price reductions on their part in order to remain competitive. A smaller number of businesses reported that tax-exempt competition resulted in layoffs or other curtailment of activities.

It should be noted that the responses I just discussed represent the views and perceptions of the businesses in the six industries and not necessarily those of the entire taxable business community. While we have no reason to doubt the sincerity of these particular respondents, we did not have the time or resources necessary to verify the existence of alleged competition or document the validity of the effects reported by the respondents.

In any event, it seems clear from these data that businesses are becoming increasingly concerned about competition from the tax-exempt community. The increasing variety of activities of tax-exempt organizations and their increasing reliance on income-producing activities may be primary sources of this concern. However, in specific terms, there is no complete data to quantify the nature, extent and effects of competition between the tax-exempt and taxable business communities. For example, what and how many businesses are affected by tax-exempt competition? Is it a local or a national problem? What are the actual effects on the businesses? Without such detailed information, it is difficult to determine whether legislative or regulatory changes are needed to address the competition issue.

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Mr. Chairman, this concludes my statement. I would be pleased to answer questions.

Number of Perceived Tax-Exempt Competitors by Businesses Within Selected Industries[a]

Industry	Projected respondents	No competitors number	No competitors percent	One competitor number	One competitor percent	More than one competitor number	More than one competitor percent	Top three types of tax-exempt competitors[b] organizations	percentage of respondents
Audio-visual	356	128	36	25	7	203	57	University or college - public	63
								Government - state or local	52
								University or college - private	43
Racquet sports	462	47	10	89	19	326	71	YM/YWCA or YM/YMHA	85
								Recreational/health/sports/ fitness club	65
								Hospital	41
Research and testing	215	34	16	4	2	177	82	University or college - public	79
								Government - state or local	60
								Research organizations	56
Tour	28	16	57	1	6	11	39	Religious organizations	60
								University or college - public	56
								Business or professional association	55
Travel agent	7,349	4,016	55	472	6	2,861	39	Religious organizations	67
								University or college - public	63
								Social/fraternal organization	60
Veterinarian	18,444	7,191	39	3,733	20	7,520	41	Human or animal welfare organization	60
								Government - state or local	24
								University or college - public	15

Source: GAO questionnaire data

[a] Percentage have been rounded to the nearest whole number.

[b] Types of tax-exempt organizations perceived to compete to a moderate, great, or very great extent with questionnaire respondents over past 6 years (1980 - 1985).

Regulating the Competition between the Nonprofit and For-Profit Sectors

Statement of Richard Steinberg
Associate Professor of Economics
Virginia Polytechnic Institute and State University
Before the
U.S. House of Representatives, Committee on Small Business
June 28, 1988

I) Overview

To understand the competition between for-profit (FP) and nonprofit (NP) organizations, one must first understand the inherent difference between these sectors. The sectors are misnamed (though I know of no wholly satisfactory nomenclature) and this has led to much confusion and, frankly, bad policymaking.

The difference has little to do with what these organizations are nominally "for" (profit or not-profit), and the size of profits is not a reliable guide to failings in either sector. Thus, public action is not necessarily warranted when NP 'profits' (surpluses) are high or FP profits are low.

The inherent difference between the sectors is given by the presence of what Professor Hansmann (1980) has termed the "nondistribution constraint." NP organizations are allowed (under their statutes of incorporation) to make profits, as long as such surpluses are not distributed to the owners of the firm (typically a board of directors). FP firms face no such constraint. While they can retain profits for internal investment, they can also distribute them to owners, typically as dividend checks. Although it is difficult to obtain data, the rate of profit appears roughly similar between the two sectors.

What is the difference in what these organizations are "for" if the answer is not "profits"? Researchers are just beginning to obtain answers here, which surely depend on the extent of effective competition within and between the sectors. Some goals can survive the ravages of competition better than others, and this is the way in which market forces determine the behavior of individual firms. In turn, the extent of effective competition between the sectors is largely determined by governmental tax and regulatory policies. Thus, it is a mistake to simply look at the current performance of FPs and NPs when reforming tax and regulatory policies for those policies determine that performance.

An (over-simplified) example will illustrate my point here. Many observers have noted that NP hospitals are currently providing only a little more charity care (if any) than FP hospitals. These observers note the apparently equal performance and question whether the special tax advantages conferred upon NP hospitals are still justified. Yet perhaps this equivalence results from a shortage of NP advantages, not a surplus. NP hospitals are facing serious and intensifying competitive pressures and have been forced to cut back on many nonlucrative activities including charity care. Perhaps if we widened the set of NP hospital tax and regulatory advantages they would choose to provide more charity care, as such care would no longer endanger survival.

The problem with tax and regulatory cushions is that they are too blunt. Although they allow a NP to do many good things, they also allow it to do socially unproductive things. One (oversimplified) example is given in the health insurance industry. Until recently, NP health insurers (such as Blue Cross and Blue Shield) were exempt from state premium taxes imposed upon FP health insurers. The extent of this tax advantage varied from state to state. Several studies concluded that the average administrative cost of processing a claim submitted to the Blues also varied from state to state in a pattern exactly mimicking the nonprofit tax advantage. Apparently, the cushion in this case was primarily 'wasted' on higher costs.

While we know that tax regulatory advantages allow NPs to both improve and hinder the overall functioning of the market, we know less about the finer details of how particular advantages impact particular industries. An understanding of these finer details is crucial to policy design, so I will discuss what is known below. Considerations of fairness are (perhaps) more important in policy design, and I turn to these first.

II) Fairness

A) Introduction

The issue of fairness has recently rearisen in discussions about the reform of the unrelated business income tax (UBIT), and I will confine most of my remarks here to this tax. However, similar equity issues arise for the entire panoply of NP tax and regulatory advantages. The discussion here usually centers around the 'level playing field' analogy, for it is alleged that UBIT's loopholes and exemptions tilt the playing field (for the game of commercial competition) in favor of the NP sector.

I do not think the level playing field analogy provides useful guidance. I am not even sure that the players on both sides are playing in the same game. Thus, I begin by proposing an alternative way of determining what constitutes fair competition. Next I highlight some difficulties within the playing field analogy. I conclude by examining the fairness of tax reform, which is different from the fairness of the tax itself.

B) A Symmetry Standard

If a FP firm is not doing very well and faces competition from a tax-exempt NP, it is only natural for the FP firm to complain that the situation is unfair. However, ethically defensible tests of fairness should not be based upon narrowly-defined concepts of self-interest. Thus, I have proposed a more anonymous test of inequity--a competitive environment is inherently unfair if one class of competitors systematically prefers the environment enjoyed by the second class but is precluded from obtaining that environment by state action. By this standard, tax-exemption is unfair if the typical owner of a FP firm would like to switch places with the owner of the typical NP and cannot. The system must be viewed in toto, not in terms of isolated privileges.

In some cases, FPs could easily convert to NP status (hospitals come to mind), and, in these cases allegations of unfairness ring hollow. FP owners may envy NP tax exemption viewed in isolation, but their behavior reveals a lack of envy for the total NP environment. If the owners of a FP hospital choose not to accept tax exemption for themselves, how can they complain of tax exemption by others?

More commonly, conversion is difficult. A FP publishing house would have to found (or buy) its own university to become a NP university press.

In these cases, the symmetry standard requires an answer to the hypothetical problem--would they switch places if they could?

It is doubtful that current owners of FP firms would wish to trade places with their NP brethren. The foremost reason for this is the nondistribution constraint mentioned earlier--unlike owners of FPs, NP owners cannot (legally) convert any portion of profits for their personal use. In addition, NP firms may have a harder time raising funds for growth as they may not issue shares of equity capital. Professor Hansmann has pointed out that NP exemption from the corporate income tax can be viewed as a crude compensation for this disadvantage. In sum, NP exemption from corporate income taxes may be *necessary* to secure fair competition, as it would countervail the inherent advantages of the FP corporate form.

C) *Formalizing the Playing Field Analogy*

It is quite difficult to make this sort of ethical argument precise and useful. Often, the argument runs in terms of what economists refer to as "horizontal equity"--the equal treatment of entities in equal situations. I know of three attempts to demonstrate that horizontal equity requires the elimination of NP tax advantages, but all seem flawed to me.

Professor Weisbrod (in a personal communication to me) developed one of these approaches, though I don't believe he subscribes to the argument. He suggested that "the competition is 'unfair' in the sense that the NPs receive subsidies for providing the same things that FPs provide without subsidy. Implicitly, the FPs are saying that fairness requires treating all providers of a 'given' output equally". This argument appears to miss the point of horizontal equity, for "output" has no moral claims to equitable treatment--only individuals can be unfairly treated. To determine whether individuals are unfairly treated by this standard, we would need them to be *in equal situations*. Manifestly they are not--the NP milieu is entirely different from that of the typical FP, so some sort of "handicapping" may be ethically justified.

Professor Rose-Ackerman (1982) suggested two other variants on the horizontal equity argument. In the first, one "compares firms within the *same* industry and asserts that it is unfair for the tax system to favor one competitor over another." Rose-Ackerman correctly pointed out that corporations *per se* have no moral interests, and that when one pierces the organizational veil and considers the interests of *people*, there does not seem to be any violation of horizontal equity principles. I would extend her argument by considering specifically the impact on the *owners* of the respective firms. The owners (stockholders) of FP firms must sacrifice *part* of their net (pecuniary) earnings to the government because of the corporate income tax. However, the entrepreneurs who establish NP firms must sacrifice *all* of the net (pecuniary) earnings because of the nondistribution constraint. Although in one case part of profits revert to the government and in the other to the NP firm, the financial impact on owners is, in the latter case, the same as a 100% tax on profits. Thus, if this variant of the horizontal equity argument is ethically persuasive, it is NPs who are the victims of unfairness!

To be complete, we must consider the nonpecuniary advantages flowing to owners of the respective firms. Owners of NP firms may receive sufficient satisfaction from the good deeds of their firm to compensate them for the 100% implicit profits tax. On the other hand, owners of FP firms could *conceivably* receive nonpecuniary benefits from services provided by government through their corporate income taxes. But the balance here is entirely speculative. The bottom line is that it is hard to establish a horizontal equity claim for imposing or extending the UBIT based on this variant.

Rose-Ackerman's second approach "compares for-profits across different industries--those with and those without tax-favored firms. Here it is said to be "unfair" for some firms to compete with tax-favored organizations when for-profit corporations in other industries compete only with taxable firms." She argued that such unfairness does not occur in perfectly competitive markets where entrants correctly foresee the presence of tax-exempt competitors. The reason is simple--with such foresight, FPs would simply choose not to enter industries if NP competition would deprive them of the competitive rate of return.

Next, she argued that unfairness of this sort could result if tax-exempt competition was unforseen at the time NPs entered an industry, exit of FPs was costly, and FPs were precluded from a 100% debt finance structure (finance structure matters because of accounting details in the corporate tax code). In this situation, FP firms would have higher costs than tax-exempt NPs, would be driven out of the industry, and would unfairly sacrifice the costs of exit from their original industry and entry into their new field of endeavor.

Rose-Ackerman also applied this argument to imperfectly competitive firms, and I have extended and corrected her argument here. In general, a single tax-favored NP firm will not drive a single competing FP firm out of business, regardless of whether the competition was foreseen (but there are exceptions). The FP is hurt by the competition, but it is hurt in a "good" way, for the FP's monopoly power and excessive profits are reduced.

D) Applying the Playing Field Analogy: Two Difficulties

The playing field is not a smooth Euclidean plane, tilted uniformly against FPs. Rather, it is curved and distorted, here favoring one side, there favoring another. If this fairness argument is persuasive, then reformers should seek a thorough renovation and not just a regrading of the playing field.

The field is bumpy for many reasons, but I'd like to illustrate two that have heretofore received little attention in the literature. First, imagine that a FP firm decided to donate its entire net income to a NP. The deduction for corporate giving is limited to 10% of net income. (Conceptually, this example works as well for a 10% contribution, but it is starker as presented. Thus, for purposes of this example, I will assume that there is no such limitation.) This charitable FP would have no taxable income and thus would pay no corporate income taxes. A competing FP which did not make donations would have higher costs (due to taxes) and would be at a competitive disadvantage. Yet, I don't think we would characterize this situation as unfair, and there does not appear to be any political attack on the corporate charitable donation deduction.

Now consider a NP firm which founds a wholly-controlled FP subsidiary earning unrelated income and returning net proceeds as dividends to its sole owner. This situation describes the earning of UBI fairly well. It is also wholly analogous to the charitable for-profit example detailed above. Yet proponents of the UBIT would regard this subsidiary as unfairly competing against other FPs, and indeed, the earnings of the FP subsidiary are taxable under current law.

I draw two conclusions from this example. First, it is logically inconsistent to support both the corporate charitable deduction and the UBIT when that deduction is unlimited. My second conclusion applies to the world as it is. Since FP firms are allowed a limited deduction for their contributions when not controlled by a NP (the current threshold allows the deduction if the FP is less than 80% controlled by a single NP), this same deduction is required if the UBIT is to truly 'level' the playing field. Thus, I propose a 10% deduction should automatically be applied to unrelated business income (UBI) before calculating the taxes owed. This deduction could substitute for the $1000 tax credit under current law, which was imposed for administrative convenience rather than out of concern for fairness.

My second example concerns competition between two hospitals. Both operate an unrelated business (say, they sell pharmaceuticals to outpatients). The first hospital is organized as a NP, and income from its pharmaceutical division is currently taxed under the UBIT. The second hospital is organized as a FP, and income from both divisions is taxable under the corporate income tax.

Suppose that both hospitals wish to provide below-cost care to the underinsured indigent, and finance this care with profits from the pharmaceutical division. The FP hospital could cross-subsidize tax free, as health care is a cost of their business and is deductible from total revenues on the consolidated income statement. The NP hospital must pay the UBIT on its pharmaceutical division earnings before it can cross-subsidize health care for the poor. The reason is that UBI cannot be offset against business losses in the NP's exempt purpose.

A similar, but less stark example arises if the two hospitals do not wish to subsidize medical care for the poor, but only to cover medical division losses in the event the community is hit by an epidemic of good health. Thus, the problem does not arise because the FP was trying to be 'charitable'. It arises whenever the NP exempt purpose faces competition from FP firms in a multiproduct setting. The problem is that FPs may receive a tax subsidy through offsets which is not available to NPs. Thus, in some cases, the playing field is tilted in favor of FPs.

E) The Fairness of Reform

One should distinguish the fairness of a tax system established de novo from the fairness of tax reform. As Professor Feldstein (1976) has argued, a tax system in place establishes a pattern of costs and benefits which is capitalized into the price structure. Applied here, his analysis suggests that if NP exemption really subsidized NP firms at the expense of FPs, FP firms would leave the industry. Any remaining firms would be indifferent to the NP subsidy. Stock prices would reflect this structure of tax subsidies. In the case of proprietorships and partnerships, the structure of tax subsidies would be reflected in the resale value of the firm.

On the other side, NP firms would enter the industry, presumably, until a marginal firm contemplating entry would anticipate a zero cross-subsidy towards its exempt purpose. (I have simplified analysis of the entry decision tremendously, but the point is still valid under available alternative analyses.) Therefore, in the long run FPs are not hurt and NPs are not helped by exemption from the unrelated business tax.

Consider an unforeseen tax reform which eliminated this subsidy to NPs after the market has obtained its long run equilibrium. The immediate effect would hardly be fair--FP stockholders would obtain windfall profits while NPs would have financial losses. Until NPs were able to dispose of their excess capacity in unrelated businesses, these businesses would drain funds away from the firm's exempt purpose. NPs can not be blamed for responding to the initial set of tax stimuli, and these losses would be in no way deserved. Changing the rules in the middle of the game can be far less fair than starting the game with unfair rules, and tax reformers should proceed with caution.

F) Fairness: A Summary

In conclusion, the current system is fair under the symmetry standard I have proposed. NPs play a separate game from FPs, and no one who is playing one game but prefers the other is precluded from doing so. Horizontal equity arguments provide little reason to reform, but if the playing field is to be leveled, both sectors have legitimate complaints about the treatment accorded the other. At a minimum, NPs should get the same charitable contribution deduction as FPs to offset against unrelated business income. Finally, any unfairness in the current system can be swamped by the inequities caused by the tax reform process, so such reform should be slowly phased in.

While fairness issues may be paramount they are so tenuous here that good public policy should depend upon other factors, to which I now turn.

(III) Behavior

A) Introduction

Competition limits the set of survivable NP behavioral patterns, and governmental policies limit this competition. Too little is known beyond this generality, but in this section I provide a framework for more specific analysis. First I detail those factors which allow NPs to pursue goals at variance with profit maximization. Then, I list some of the ways NP performance may differ. I follow with some implications for tax and regulatory policy. Tax and regulatory policy is a relatively blunt instrument for achieving social goals, so I also consider (in general terms) two more focused alternatives--direct governmental provision of services and increased governmental regulation of permitted activities by NPs.

B) Factors Allowing NPs to Pursue Diverse Goals

To emphasize the impact of competition on NP behavior, I will start with a simple and unrealistic model. I imagine a world where NP and FP firms coexisted in the same market, and FP firms sought an output/quality mix and production technique that would maximize their profits. Imagine also that NPs had no special tax or regulatory advantages and received no donations or dues. Consumers care only about price and quality and not about the sector of production. Finally, there are no restrictions on entry of new firms.

In this world, FP and NP behavior must be identical, at least in the long run. If any particular firm tried to charge a higher price (quality fixed) or sell a lower quality product (price fixed) than the prevailing market levels, that firm would lose all its business and would not survive. If a firm tried to charge a lower price (quality fixed) or sell goods of a higher quality (price fixed), its competitors would be forced to match this action or go out of business. There would still be diversity in quality levels, but an increase in product quality must be exactly counterbalanced in the minds of consumers by an increase in product price. The sorting out of firms by quality level is essentially arbitrary, and there is no reason to think that quality would systematically differ between the two types of firms.

All firms would have zero economic profits (economic profits are essentially equal to the difference between accounting profits and a "normal rate of return"). If any price/quality combination represented in the marketplace allowed a firm to make economic profits, a new firm would enter with a lower price/higher quality package that would be profitable and drive the first firm out of business.

The hypothetical example highlights the necessity of a "potential-profit cushion" if we expect NP performance to differ in any way from that of the FP sector. Thus, paradoxically, (potential) profits are essential for the distinct performance of nominally non profit organizations.

Three factors can provide this cushion. The first is non-sales revenue such as donations, membership dues, and grants. This provides a NP cushion, but only when the intrasectoral competition is not too severe. If too many NPs compete among the same group of donors, the net returns to any one firm become vanishingly small. We do not know enough about the determinants of the creation of new NP firms to predict the extent of future intrasectoral competition, but donations have provided a major cushion to certain NP industries for quite some time and I don't think this cushion will vanish.

The second factor is explicit governmental restrictions on entry of new firms. The certificate-of-need programs for certain health care facilities are an example of this sort of restriction. Nominally in place to reduce costs associated with wasteful duplication, these programs appear to actually reduce competition and generate a cushion at both FP and NP firms (according to the analysis of Professors Wendling and Werner, 1980). I should note that this sort of cushion does not provide the same freedom to FP firms as to NPs. If a FP firm were to depart too drastically from the goal of profit maximization, it could use its cushion to survive but would become ripe for a takeover bid.

The third factor is differential tax and regulatory treatment. Thus, if NP firms have lower costs of production due to exemption from various taxes, they can sell at the FP price and obtain a cushion which allows them to pursue other goals.

I should note that (absent governmental contracts with FPs) there are industries in which NPs can expect no FP competition as the product cannot be sold. These are industries where the benefits resulting from provision of a good or service cannot be restricted to the paying customers. However, these are also industries in which NPs cannot obtain sales revenue, so the cushion here must, again, be provided by donations and grants.

C) Possible NP Behavior

NPs could use the freedom provided by cushions in a number of ways, both good and bad for society. I will refer to these collectively as 'good deviations' and 'bad deviations.' One bad way to spend the cushion is on sheer waste as, apparently, nonprofit health insurers did (though the evidence is far from definitive).

An even worse way to spend the cushion is partly on waste and partly on increased market share. The reason this is so bad is that more efficient FP producers can be driven out of business by less efficient NPs solely on the basis of governmental subsidies. This, and not "unfairness," is the chief danger from "unfair competition" in my opinion.

Finally, the cushion may be devoted to higher NP salaries or perqs. Nothing is really wasted, but this would be bad if some workers who were especially well-suited to work in the FP sector were employed in NPs solely because of a governmentally-supplied cushion. In addition, higher salaries might be regarded as unfair (but we have the progressive income tax and welfare system to remedy unfairness of this sort).

The cushion could instead be applied to socially productive uses. Chief among these is 'trustworthiness.' In cases where consumers are ill-informed and natural market remedies (such as guarantees, repeat business, or private certification agencies) are weak, FP firms have a strong incentive to exploit their customers's ignorance. Indeed, if they didn't exploit this ignorance, they'd be driven out of business by greedier competitors who did (or perhaps, they'd be subject to a hostile takeover bid). Consumer protection laws and governmental licensing requirements can reduce, but not eliminate, this incentive for FPs to cheat their customers. Thus, an analysis of nursing homes in Wisconsin by Professors Weisbrod and Schlesinger (1986) found no significant difference in consumer complaints to state regulators on matters covered by explicit governmental regulations. However, there were significantly more complaints against FPs on matters not covered by any regulation. NPs are not subject to takeover bids and, if a sufficient cushion is available, can treat their customers honestly.

I should mention that if the public were fully informed on the difference in trustworthiness between the sectors, then no cushion would be necessary. FP prices would be set to cover the costs of an untrustworthy product, and NP prices would cover the higher costs associated with honesty. Some consumers would be willing to pay more to assure honesty, others would be willing to accept risks for a bargain.

Unfortunately, it is not possible to perfectly enforce the nondistribution constraint, so consumers need to be leery of "For-profits in disguise" (FPIDs). If consumers could not reliably distinguish true NPs from FPIDs, they would not be willing to pay a price for NP output which was sufficient to cover the costs of honesty. Thus, a cushion is necessary if any honest behavior by NPs is to survive (though some dishonest FPIDs would also survive).

NPs could also devote their cushions towards provision of goods with external benefits (i.e.-the purchaser is not the only beneficiary). Traditional charities fit in this mold, for when one donor "purchases" help for the impoverished to assuage a sense of moral responsibility, she helps not only herself but also the recipient and (less obviously) other potential donors to the same cause. External benefits are associated with many other outputs of NPs in the fields of health, day care, research, education, and arts and culture. However (with minor and technical exceptions), it is one of the best established propositions in economics that competitive FP firms will underprovide goods of this sort.

Professor Holtman (1983) has pointed out a related point. In cases where service demand fluctuates (such as medical care), excess capacity has external benefits because it reduces the risk that any individual will be denied use of facilities in times of excess need (epidemics, major accidents, etc.). FP firms provide little excess capacity (again, they'd be stockholder targets if they provided too much), while NP firms face no such constraint. A sufficient cushion allows them to be there in time of need. Incidentally, although this excess capacity is socially valuable, it has appeared as a cost-inefficiency in many carelessly done empirical studies.

D) Implications for Overall Tax and Regulatory Policy

In this section, I'd like to lump all tax and regulatory factors together and consider only the size of the cushion which is thereby provided to NPs. A small cushion forces NPs to behave like FPs. A large cushion allows both 'good' and 'bad' NPs to deviate from such behavior. Thus, (to the extent possible) we ought to provide greater advantages to those industries where the "good" deviations are likely to predominate. How can such a policy be implemented?

We know too little about the determinants of behavior, but the so-called donative NPs (those that receive the bulk of their resources from sources other than sales) are good candidates for subsidy. The fact that people are willing to make donations is a clear sign that at least some of the cushion is devoted toward goods with external benefits. The problem here is that donors may be misled by fraudulent solicitation practices. To some extent, this problem can be reduced by self-policing, public regulation, and disclosure requirements, though an analysis of this is beyond the scope of the present paper.

At the present time, few of the tax and regulatory advantages accorded to the NP sector are contingent on receipt of substantial donations. I think that this committee should devote more thought to instituting a "public support" test for some of these advantages.

A second factor determining whether good deviations are likely to predominate is the extent to which 'non-inurement' can be enforced. While the nondistribution constraint defining the sector proscribes distribution of profits to the board of directors, the non-inurement clause is broader and belongs to the federal tax code. This clause restricts charitable exemption from the corporate income tax to organizations "no part of the net earnings of which inures to the benefit of any private shareholder or individual" (I.R.C. 501-(c)-(3)). An organization which gave out no dividend checks but allowed its manager to keep all the profits would be a NP organization (if the manager were not an owner-i.e., not on the board of directors) but would violate non-inurement.

Non-inurement makes NP organizations more trustworthy. If the manager can keep an inordinate share of profits, he or she has a financial incentive to cheat the firm's customers and clients. Non-inurement removes this temptation. In the long run, managers who are good at cheating customers will sort themselves into positions where this behavior is rewarded, and thus leave the part of the NP sector where non-inurement is enforced. Thus, enforcement of non-inurement creates both short- and long-run incentives for trustworthy behavior.

Non-inurement may also raise the efficiency with which tax and regulatory breaks are translated into social good provision, though this is less assured. On the one hand, a manager who receives fixed monetary compensation has less incentive to keep costs down than does a manager who receives profit-sharing. On the other hand, profit-sharing means that a share of tax and regulatory breaks will be diverted from social good provision to managerial compensation.

Exemption from the corporate income tax is now contingent on non-inurement, and perhaps it makes sense to increase the IRS's resources for enforcing this clause. Once that is done, one can be more confident that other tax and regulatory advantages will lead to good deviations, so perhaps these should be made contingent on non-inurement as well.

One problem which the courts and IRS are now struggling with is whether all managerial incentive-type contracts violate non-inurement. We would like to retain exemption for firms employing contracts that appropriately balance the conflicting factors detailed above, but this is not an easy task. This committee might like to study the problem further and contribute legislative guidance on non-inurement.

E) Alternatives

So far, I have suggested that tax and regulatory breaks should be granted to NP organizations to allow them to practice 'good deviations'--to act in a trustworthy fashion and provide socially valuable goods which are underprovided by for-profit firms. But good deviations may be accompanied by bad deviations. To some extent, this can be limited by making tax and regulatory advantages contingent on public support and/or non-inurement. Perhaps the fine details of the tax and regulatory structure can be refined to further promote good deviations (though an analysis of such fine details is beyond the scope of this paper). Still, the 'cushion' is a relatively blunt policy instrument.

Several alternatives come to mind. The government could directly produce those goods which are underprovided by for-profit firms, or it could contract out. The problem here, pointed out by Professor Weisbrod, is that governments sometimes underprovide these goods as well. Governments tend toward a middle ground, producing in accord with the tastes of the median (middle-preference) voter. While the legislature has the power to approve a higher level of public provision, it is better for high-demanders to supplement tax payments with voluntary donations than to force higher taxes on low- as well as high-demanders. Careful analyses (which I recommend to this committee) by Professors Douglas (1987) and Salamon (1987) detail other factors relevant to the government/nonprofit division (omitted here for reasons of brevity).

The government can certainly increase enforcement of fraud statutes, product safety laws, disclosure requirements, and similar legislation. However, when non-inurement is enforced and a cushion is provided, the NP sector is more trustworthy. Retaining an inherently trustworthy organizational form seems more certain than legislating honesty.

F) Behavior: A Summary

We do not yet know enough about the factors determining NP behavior to fine-tune policy. We do know that tax and regulatory advantages allow NP behavior to deviate from FP behavior, and have some hints about how to encourage good deviations. Flawed as these policies are, they seem to provide a superior, decentralized, and pluralistic alternative to more direct governmental action.

IV) Efficiency and Unrelated Business Income

A) Introduction

Most of the discussion so far on NP behavior concerns the NP's primary activity (or 'exempt purpose'). Here we consider the treatment of unrelated business income (UBI) in both the tax and regulatory codes.

Received wisdom on the subject (which I imagine other speakers before this committee will discuss) is that it would be efficient to extend the UBIT to all unrelated and/or commercial activities while continuing to exempt related income. I will argue that the situation is more complicated. First, I describe efficiency in an ideal world. Then, I show the basic tradeoff faced in obtaining efficiency through a UBIT. I then discuss various non-tax alternatives, and conclude with a summary.

B) Efficiency in an Ideal World

In this imaginary world, all firms would invest in new capital solely on the basis of social costs and benefits. The allocation between related and unrelated activities by NPs would be determined by social fundamentals, not idiosyncracies of the tax code. We'd expect to see multiproduct firms in both sectors.

Multiproduct firms are the natural consequence of economies of scope. Simply put, certain combinations of activities are naturally undertaken within the same firm either because of cost complementarities or demand complementarities. Efficiency gains may be due to economies of joint production (as in bacon and pork chops), to utilization of spare capacity (as when a university sports stadium is rented out for a rock concert), to economies of scale (as in commercial and residential power generation), or to ease of consumption (as in the convenience of a giant supermarket). When such economies of scope are present, seemingly unrelated activities are naturally undertaken by a single firm. Such conglomerations help society, for they allow production to take place without waste of scarce resources.

Professors Posnett and Sandler (1986) argue that economies of scope help explain charitable contributions to donative NPs. They note the free rider problem, where individual donors are reluctant to contribute because they obtain a tiny fraction of the societal benefits financed by their contribution. If NP firms tailor their fundraising campaign to provide private goods which are complementary to the public good, the free rider problem is largely overcome. They present considerable evidence that fundraising campaigns in both the U.S. and U.K. follow this strategy. Thus, demand-side economies of scope are likely to be endemic in the donative-financed part of the NP sector.

C) The Basic Tradeoff

Now let us consider the real world. Corporate investment decisions are distorted by the corporate income tax which is largely a tax on capital. The exact incidence of the corporate tax and the magnitude of reduced and misallocated investment due to the tax remain controversial, but there is no doubt the tax is distortionary. One oft-cited study by Professors Ballard, Shoven, and Whalley (1982) estimated the marginal excess burden of the corporate income tax (that is the additional non-tax costs to society resulting from a $1 corporate tax increase) at 49\ per dollar. This is a good deal higher than the excess marginal burden caused by other federal taxes.

It would seem that, rather than extending the corporate income tax further, we ought to be repealing it. In one of his less politically perceptive (but more intellectually perceptive) moments, President Reagan stated: "I'll probably kick myself for having said this, but when are we going to have the courage to point out that in our tax structure, the corporation tax is very hard to justify?"

Repeal of the corporate income tax appears to be as political impossibility at this time. Under the current system noncorporate and most nonprofit income is untaxed. Differential taxation induces additional distortions--nonprofits may be induced to enter unrelated businesses when such entry is not socially justified by economies of scope or otherwise. NPs receive an incentive to overinvest, while FPs underinvest. Finally, NPs may use part of the cushion provided by their tax advantage to increase bad deviations.

Received wisdom has stressed the distortions due to differential taxation, and has recommended that these distortions be eliminated by extending the UBIT. This is clearly a second-best option dominated by elimination of the corporate income tax. What is not clear is whether the value of increased investment in the NP sector (resulting from exemptions) outweighs the costs due to differential treatment. Elimination of the UBIT may be a better 'second-best.' I have no answer here but feel the issue deserves further attention.

D) Analysis of Specific Policies

One policy change, recommended by Frank Swain, the Chief Counsel for Advocacy of the Small Business Administration, is to legislate and tighten the ceiling on commercial activity used by the IRS in determining whether a NP deserves tax-exempt status. Currently, that ceiling is set by administrative fiat at 50%. Mr. Swain argues (1987): "When the ceiling is exceeded, the organization should be presumed to be operating as a for-profit business and, unless proven otherwise, denied its tax-exempt status." Mr Swain, like others, is concerned that the unrelated tail may be wagging the exempt-purpose dog. In his recent book, Professor Weisbrod (1988) summarized the pros and cons of this position:

> "...Competition with proprietaries should stimulate efficient production, diversify revenue sources, and perhaps provide a stimulus to greater creativity. [On the other hand], becoming a multipurpose organization is likely to pose new administrative and managerial problems and, most important, the pressure to perform profitably in the competitive marketplace can divert' resources and energy from the organization's principal public-type purposes even while total resources are being expanded."

The problem with fighting the disadvantages of commercial diversification by a uniform artificial ceiling is that it doesn't recognize the varying incidence of economies of scope. It may well be, in certain cases, that an efficient organization involves tail-wagging.

Several proposals would directly or indirectly limit fundraising activities. In June 1986, the Postal Rate Commission recommended to the Congress that only material related to an organization's exempt purpose be mailed at reduced rates (GAO, 1987). Surveyed FP businesses suggested that the exemption from UBIT of income from activities provided for members' convenience be eliminated (GAO, 1987). Mr. Swain (1987) recommended that the definition of related income be narrowed to state: "for example, that 'business income will only be related, and therefore exempt, if the activity generating the income is so fundamental to the existence of the exempt purpose as to be a mere extension of it, capable of standing alone to fulfill the exempt purpose of the organization."

All of these proposals would have the effect of limiting economies of scope of the sort discussed by Posnett and Sandler. Organizations would be taxed on those activities complementary to donations, and would be forced to use a less efficient means of fundraising. Since a concern with fundraising costs is evident in much of our current regulatory policy towards NPs, it would be ironic indeed if restrictions on UBI led to reduced efficiency in solicitation.

Finally, proposals to make NP commercial activities illegal per se or to tax them at higher rates than corporate income are obviously inefficient. Socially optimal economies of scope could not be obtained in such a regime.

E) Efficiency and UBI: A Summary

On the one hand, the various loopholes and exemptions to the UBIT encourage NPs to compete in industries where they have a natural cost disadvantage. This disadvantage is overcome because of tax treatment, not market fundamentals. However, in some cases, the alternative to costly NP provision is no provision at all, even though provision of the product is innately desirable. This is because the corporate income tax is also distortionary, and sometimes is the sole reason why FPs do not provide certain products.

Non-tax restrictions on commercial activities by NPs could, in theory, improve the allocation of society's scarce resources. However, it would be impractical to develop policies which are sufficient by fine-tuned as to allow desirable commercial activities by NPs.

V. Conclusion

NP organizations predate FPs (and perhaps even governments), and the division of activities between these sectors, which fundamentally defines the character of a civilization, has changed substantially over the centuries. Public policy towards this division has developed in a piecemeal fashion, which is understandable in light of our ignorance of the underlying behavioral processes. We are now approaching that threshold where we know enough to consciously design an integrated policy. These hearings can only help encourage the research necessary to cross that threshold.

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WORKING DRAFT

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COMMERCIAL ACTIVITIES IN HUMAN SERVICE ORGANIZATIONS

by

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COMMERCIAL ACTIVITIES IN HUMAN SERVICE ORGANIZATIONS

Judging from recent newspaper accounts, a massive transformation is under way in the nation's private, nonprofit sector, with nonprofit organizations forsaking their traditional activities to rush headlong into the world of business. Headlines such as "The Nonprofits Drop the 'Non'";[1] "Arts, Education Groups Now Making Millions";[2] "Academia Using Strategy from the Corporate World";[3] and "Cultural Institutions Join Money Hunt"[4] convey the idea that nonprofit organizations have abandoned their social and charitable mission and joined the Wall Street business corps. Based on such perceptions, advocates for the small business community have raised a storm of protest claiming that nonprofit organizations are beginning to compete unfairly with tax-paying businesses in traditional business fields.[5]

But how pervasive is this nonprofit penetration into the world of business? Unfortunately, most of the discussion to date has had to rely on anecdotal information portraying the business successes of one or two select agencies. What has been lacking, however, is systematic, empirical data that can put these anecdotes into context and portray more fully the extent and character of business activity in the nonprofit sector.

Fortunately, data collected as part of The Urban Institute's Nonprofit Sector Project, a national, longitudinal study of more than 3400 nonprofit human service agencies, exclusive of hospitals, higher education institutions, and private primary and secondary schools, make it possible to remedy this shortcoming.[6] What these data suggest is that the movement of nonprofit organizations into new business ventures is far less pervasive or significant than recent newspaper accounts would suggest. At the same time, the data show that nonprofits are increasing their reliance on at least one type of commercial income that has been used extensively in the past, but that has been largely overlooked in recent accounts—namely, charging clients fees for service. In other words, there are really two very different types of commercial activity occurring within the nonprofit sector, each having a somewhat different impact upon the financial base of the sector. The purpose of this article is to shed some empirical light on these activities and thus provide a better understanding of the commercial nature of nonprofit activity.

To do this, the discussion here falls into four sections. Section I defines more completely the two types of commercial activities in which nonprofits are involved — "ancillary business activities" and "fee-for-service activities". Section II then draws on our survey of nonprofit human service agencies to document the extent, incidence, and recent changes in the ancillary business activity of nonprofits. Section III does the same for fee-for-service activity. A final section discusses the implications of these findings.

I.
What Is Commercial Activity?

Recent press accounts and government documents on the growth of nonprofit business activity have tended to lump together a number of different activities that deserve to be treated separately. In particular, it seems reasonable to differentiate between two quite different types of commercial activity in which nonprofit organizations can engage. The first type, which has received the most attention, involves the sale of products that are ancillary to a nonprofit organization's central mission. Examples here would include nonprofits that take advantage of their computer systems to market data processing services, or organizations that sell travel services or insurance to their employees or others at a profit. Also included would be museum gift shops that market replicas of art objects and other items. The central characteristic of these activities is that the nonprofit organization develops a "product" that is ancillary, though not necessarily unrelated, to its basic mission, and then markets this product for a profit. We will refer to this as "ancillary business activity."

Far different from this kind of ancillary business activity is the more traditional nonprofit practice of charging clients fees for the services they receive. Such fee-for-service activity has long been a characteristic feature of the private, nonprofit sector. It includes tuition fees in private colleges and universities, payments for day care services, hospital stays, and the like. In some cases, clients do not pay the full cost of the services they receive but rather benefit from income that nonprofits receive from private charitable sources, third-party payers, or government grants. In many cases, agencies operate sliding fee scales and offer services at lower cost to those in greatest financial need. This form of activity differs quite markedly from the "ancillary business activity" mentioned above. Yet, despite its long history, we know very little empirically about fee-for-service income and are therefore in a weak position to gauge its extent or character. Indeed, in most accounts of the commercial activity of nonprofit organizations this traditional fee-for-service activity is overlooked. It is therefore important to put these two types of activity next to each other and to see which is the more important and how extensively each is used.

II.
Ancillary Business Activity

Respondents to our survey of nonprofit service agencies were asked to record the share of their income coming from each of ten different sources of support, including government, individual giving, United Way, corporations, foundations, religious and federated giving campaigns, fees, endowment, and other. The "other" category included both sales of products and special fund-raising events such as raffles, banquets, or testimonial dinners. If anything, this "other" category therefore probably overstates the extent of "ancillary business activity" within the nonprofit sector. Using these data, how extensive was this activity? What proportion of the income of the nonprofit human service sector comes from this source? What share of the agencies utilize this type of income? Which types of agencies are most dependent on these revenues? And what are the recent trends in this type of commercial activity? The purpose of this section is to answer these questions.

Extent

Despite the recent flurry of interest and the growing chorus of small business complaints, the extent of nonprofit involvement in ancillary business activities is relatively small. As of 1981, only 6 percent of total nonprofit human service agency income came from ancillary business activities and special fund-raising activities combined, as reflected in figure 1. What is more, among the agencies in our study that provided complete financial information for the period 1981 to 1983, little significant change occurred in the extent of income originating from such business activities.

Not only are the dollars generated by ancillary business activities rather limited, so are the numbers of agencies involved in such activity. As of 1981, only 22 percent of the agencies reported income either from special fund-raising events or the sale of products. While the percentage of agencies receiving this type of income grew somewhat between 1981 and 1983, the growth was quite limited. Less than one-third of the agencies (30 percent) reported some tie to either business income or special fund-raising activity by 1983.

Incidence

Not only is income from business activity rather small, it is also concentrated in particular portions of the nonprofit sector. This is evident in table 1, which records the share of income originating from each of five principal sources of support for different types of nonprofit agencies. As this table makes clear, for only two types of agencies--those engaged in employment and training and those engaged in arts and culture—does business income constitute more than five percent of agency income, and even for these agencies, business income is far from the dominant source of support. As of 1981, therefore, business income remained confined, essentially, to the arts sector and to agencies primarily providing employment and training programs.[7]

Trends

While business income comprises a far smaller share of nonprofit income than is sometimes assumed, this income has increased in recent years, as nonprofits have struggled to cope with government cutbacks. In particular, while total nonprofit income grew by 6 percent between 1981 and 1983, income from the combined sales/other fund raising category grew by 23 percent (see table 2). However, this percentage figure is somewhat misleading in view of the small base from which this sales/other income began. In fact, of the $57,300 in new income that the "average" agency in our sample generated to offset losses from government funding, only $7900, or 14 percent, came from either product sales or special fund-raising events.

What is more, only a small segment of the sector reported signficant increases in actual dollar terms from this source of income. Employment and training agencies, culture/arts/recreation organizations, and legal services/advocacy groups, each earned more than $10,000 in new revenues from the sale of products or special fund-raising events. But all other types of agencies earned much less, and in fact, two types of agencies—housing/community development and multiservices—actually lost revenues from this source of support. Clearly, ancillary business activity has not proved to be the most promising way of increasing nonprofit agency revenues.

Responses to a question about the extent to which nonprofit organizations had established for-profit subsidiaries underscore this point. Only 7 percent of the agencies responding to this question in 1983 indicated that they had set-up such subsidiaries in the prior two years. And only 16 percent indicated that they were even contemplating such action over the next two years.

In short, to the extent that "ancillary business income" is what observers have in mind when they talk about the growth of commercial activity in the nonprofit sector, this activity remains quite limited both in scope and scale. Such income constitutes a rather small share of the total revenues of the sector and affects less than one-third of the agencies. Only in two fields does this income represent a signficant source of support, and even here it is far from dominant.

III.
Fee-for-Service Income

Extent

While the ancillary business activity that has attracted so much attention in recent years accounts for only a relatively minor share of nonprofit income, the other type of nonprofit commercial activity—charging fees for the provision of services—is quite substantial. As reflected earlier in figure 1, such fee income accounted for 28 percent of all nonprofit human-service agency income in 1981. This made it the second most important source of revenue for the nonprofit sector, behind government but ahead of private giving. What is more, this source of support was extremely widespread: nearly 70 percent of the agencies reported receiving income from this source—higher than for any other single source.

Incidence

Not only is fee-for-service income important for the sector as a whole, it also is important for the many and varied components of the sector. In fact, for six of the ten types of agencies cited previously in table 1, fee income ranked either first or second among the sources of nonprofit income. In no service field does the share of fee-related income fall below 10 percent. Fee-for-service revenue plays a particularly large role in the funding of agencies engaged in non-hospital health care, institutional care, education and research, and arts and culture. In fact for health care agencies, fee income actually comprised over half of all support.

Trends

Not only did fee income enter the 1980s as a major source of nonprofit income, it also proved to be a mainstay in coping with budgetary pressures of the early 1980s. As government revenues declined, nonprofit agencies turned overwhelmingly to fee-for-service income to make up for budgetary shortfalls. Between 1981 and 1983, fee income rose by 21 percent, raising approximately $33,900 in new revenue for the average nonprofit agency in our study (see table 2). This growth in fee income represented about 60 percent of all new revenues to the sector and was approximately four to five times more important than income from product sales in allowing nonprofits to recover from government funding cuts in the early 1980s.

Morover, this increase in fee income was quite widespread throughout the nonprofit sector. All types of agencies in our study reported increases in fee income and only one type of agency--those providing housing and community development services--reported a gain of less than $10,000.

IV.
Conclusions and Implications

If observers of the nonprofit sector define "commercial activity" to mean the sale of products or some other type of entrepeneurial venture, then nonprofit organizations, in the aggregate, are not particularly commercial in their method of operation. Only a small percentage of nonprofit agençies engage in such ancillary business activity, and the revenues generated by these activities are relatively meager.

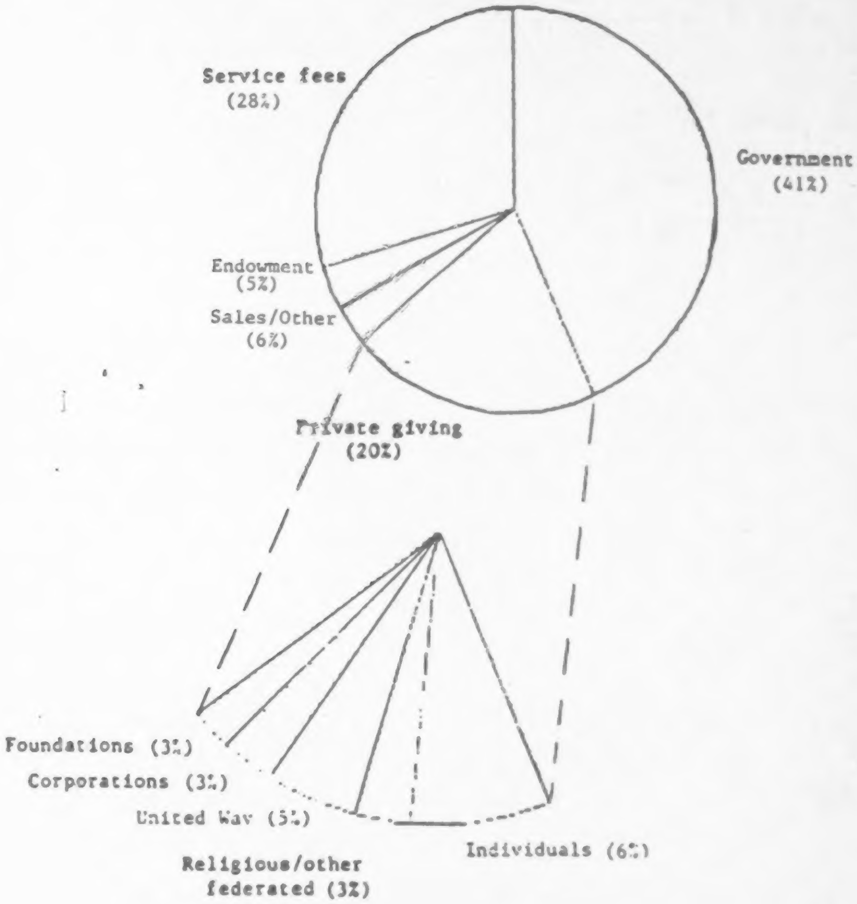
If the definition of "commercial activity" is expanded to embrace fee-for-service payments, however, the nonprofit sector has a massive commercial involvement, and has had for decades. What is more, this fee-for-service activity is growing at an extremely rapid rate, as nonprofits have lost government support and been forced to turn elsewhere for income. In the process, serious questions are raised not about the sector's intrusion into traditional commercial arenas but about its ability to continue to serve those in need. In fact, based on the data reviewed here, there is probably more reason for nonprofits to be concerned about business penetration into traditional areas of nonprofit activity and creaming off clients who are able to pay for services than for-profit businesses to be concerned about nonprofit penetration into the for-profit business arena, thereby providing services at tax-subsidized, below-market costs.

At the present time, however, too little is known about the most significant form of nonprofit commercial activity, namely, fee-for-service arrangements. We do not know, for example, how nonprofits set their fee structures, what share of costs they cover through their fees, how sliding fees operate in practice, and how nonprofit fees compare with for-profit ones in the same fields. All of this suggests that the recent interest in commercial involvement on the part of nonprofit organizations has tended to focus on the wrong phenomenon. Despite their novelty and ingenuity, the real growth area for nonprofits, and the one with the greatest potential for altering the basic character of the sector, is not ancillary business activity, but fee-for-service income. It is here, therefore, that the need for additional research is greatest.

Figure 1

SOURCES OF INCOME FOR
NONPROFIT HUMAN SERVICE ORGANIZATIONS,
1981

($\underline{n}$ = 2,304)



Source: The Urban Institute Nonprofit Sector Project, round I survey.

Table 1

SOURCES OF INCOME FOR NONPROFIT AGENCIES BY TYPE OF AGENCY 1981

Type of Agency	Percentage of Income from Each Source Government	Service Fees	Private Giving	Endowment/ Investment	Sales/ Other
ALL AGENCIES	41%	28%	20%	5%	6%
Primary Service Area					
Mental health	67	23	7	3	*
Housing/community development	62	19	16	2	1
Legal services/advocacy	62	10	23	1	4
Social services	57	13	25	3	2
Employment/training	55	10	13	3	20
Institutional/residential care	51	32	11	3	2
Multiservice	47	22	25	3	3
Non-hospital health care	31	51	13	2	3
Education/research	28	31	25	9	4
Culture/arts/recreation	15	27	30	11	16

*Less than one percent.

NOTE: Percentages may not sum to 100 because of rounding.

SOURCE: The Urban Institute Nonprofit Sector Project Survey, round I.

Table 2

Changes in the Average Income of Nonprofit Agencies, by Source of Funding 1981 - 1983

Inflation-adjusted Data
(n = 1,508)

Source of Income	1981 Income	Change, 1981-1983	
		Amount	Percentage
Government	$288,243	-$12,939	- 5%
Service fees	164,119	+ 33,880	+21
Private giving	168,694	+ 9,848	+ 6
Endowment	25,843	+ 5,630	+23
Sales/Other	34,234	+ 7,927	+23
TOTAL FUNDING	$680,271*	+$41,270*	+ 6%

*Individual sources may not add to totals because of minor discrepancies in reporting by responding agencies.

Note: The 1981 revenue data reported here are slightly different from the data reported in figure 1 because these data are based only on respondents that answered both the first- and second-round surveys, thereby providing us with financial information to 1983. Data in figure 1 are derived from all respondents to the initial round I survey covering the period 1981 to 1982.

Source: The Urban Institute Nonprofit Sector Project, round I and round II surveys.

Notes

1. New York Times, November 24, 1985.
2. Washington Post, November 24, 1985.
3. Washington Post, November 25, 1985.
4. Washington Post, November 26, 1985.
5. U.S. Small Business Administration, "Unfair Competition".
6. In 1981, The Urban Institute undertook a major project to examine the scope, structure, and funding base of the private, nonprofit sector in the United States. This project involved work at the national level and in sixteen local field sites selected to provide a reasonable cross-section of the nation in terms of geographic region, size of community, socio-economic condition, and level of philanthropic activity. The study focused on nonprofit human service organizations, such as day care centers, programs for the elderly, youth groups, museums, art galleries, symphony orchestras, YMCAs, job training centers, and similar types of service providers. Hospitals and higher education facilities were excluded from the study because information was already available on these types of organizations from other sources. Primary and secondary schools were excluded because the finances of the school are often intermixed with those of the religious institutions with which many are affiliated. The findings reported here draw chiefly on the results of two mail surveys administered to over 7000 nonprofit, public-benefit, service organizations located in our sixteen study sites. The first of these surveys was conducted in late 1982 and early 1983 and yielded over 3400 responses. A follow-up survey was then administered in late 1984 to all first-round survey respondents. A total of 2300 agencies completed the second questionnaire. The findings of these two surveys thus provide a picture of how a cross-section of nonprofit agencies throughout the country have been affected by recent changes in public policy and how they have responded to financial pressures created by such changes.
7. Arts organizations receive commercial income through museum gift shops or the sale of concert/performance memorabilia. Employment and training programs, particularly if they are designed as rehabilatative or instructional workshops, may sell the products produced by their clients through commercially-oriented outlets.

Testimony before the U.S. House of Representatives
Committee on Small Business
June 28, 1988

Dennis R. Young
Director, Mandel Center for Non-Profit Organizations
Case Western Reserve University

Mr. Chairman, Members of the Committee:

I am pleased to have the opportunity to appear before this committee and to offer you my observations on the issue of competition between business and nonprofit organizations. I speak to you as one who heads a new university center devoted to research on nonprofit organizations and to educating managers and leaders of these organizations. From this vantage point, it is clear to me that the initiatives that nonprofit organizations have taken in recent years to enhance earned income through surplus-producing ventures have been prompted by the increasingly stringent economic environment in which they operate. The intent of these organizations has overwhelmingly been to maintain their service programs in the face of reduced support from other revenue sources. Thus, while it is important to determine whether such initiatives impact unfairly on the business sector, it is also imperative that the needs of the nonprofit sector be given adequate consideration.

That nonprofit organizations perform vital functions in our society is clear from their concentration in key service areas including health care, social services, education, arts and culture, and religion. Together these industries accounted for 80% of the employees and 96% of the operating expenditures of deductible, tax-exempt organizations in 1984 (see Hodgkinson and Weitzman). Within many of these industries, nonprofits operate side by side with profitmaking and/or governmental providers, but even in these contexts nonprofits offer distinctive varieties of service. While comparisons of quality, efficiency, responsiveness or other measures of performance are difficult, it is clear that profitmaking firms, government bureaus, and nonprofit agencies are not simple substitutes for one another. (For example, a recent study by Prof. Burton Weisbrod demonstrates significant differences in quality of service between nonprofit and proprietary nursing homes; see Weisbrod, 1988.) In short, much would be lost if the private university, the community hospital, the nonprofit day care center or nursing home, or the nonprofit orchestra or museum could not maintain itself.

Nonetheless, particularly from the inception of this decade, nonprofit organizations have found themselves in a fiscal squeeze stemming from a number of major economic and policy developments. Prominent among these developments have been significant contractions in federal expenditures in support of services provided by the nonprofit sector. As research by the Urban Institute has clearly demonstrated, social services, education, and non-insurance related health care were significantly and adversely affected. For example, setting aside Medicare and Medicaid, federal spending in fields where nonprofits are active declined 14% per year, in real dollars, over the FY 1982 to FY 1986 period, translating into losses of $23 billion for nonprofit organizations (see Abramson and Salamon). As a result, the steady growth and development of the nonprofit sector, which had proceeded smoothly over the previous decade, appears to have come to a halt in this decade. For instance, nonprofit shares of the national economy, measured in terms of national income, earnings from work, employment, and numbers of organizations, all of which had been increasing from 1977 to 1982, each declined after 1982 (see Hodgkinson and Weitzman).

Tax reform has been another source of difficulty for the nonprofit sector. Provisions of the 1986 Tax Reform Act, including reductions in personal marginal income tax rates and elimination of above-the-line deductions for non-itemizers, threaten to limit or reduce the ability of nonprofit organizations to raise funds from charitable contributions. In short, it now costs more to give. Prof. Lawrence Lindsey has estimated the annual loss of charitable contributions at 10 to 13 billion dollars (see Lindsey). Even without the new reforms, prospects for compensating governmental expenditure reductions with increased giving were unrealistic, as there was little reason to believe that giving as a proportion of national income could be radically elevated from its remarkably stable pattern over the past several decades. (Between 1970 and 1985, for example, charitable deductions as a percent of personal income fluctuated randomly between 1.77 and 2.01 percent; see American Association of Fund-Raising Counsel).

Finally, pressure on nonprofits has come from the business side, as many service areas traditionally reserved for nonprofits have been opened to profit sector competition. This has been particularly true in the health sector. Stimulated by the implementation of Medicare, Medicaid, states' mandating of private insurance coverage, and Title XX of the Social Security Act, market shares of proprietary agencies in hospital, nursing home, mental health, and other health-related services have increased dramatically (see Marmor, Schlesinger, and Smithey). Some of this pressure has been particularly insidious, as it has reduced the ability of nonprofit organizations to subsidize certain socially important services which are loss-making with surpluses from other services that are able to generate a positive financial return. Profitmaking suppliers tend to compete away the lucrative services of nonprofit suppliers, pressuring those nonprofits to reduce their internal subsidies and go head to head with business for services that can pay for themselves.

Given this confluence of economic pressures, it is unsurprising that nonprofits have begun to turn to enterprise as one strategy of survival and support for their social missions. Thus, addressing the issue simply in terms of the effects on business, and not the viability of the nonprofit sector, would ignore the roots of the problem.

In order not to blow it out of proportion, the problem of nonprofit participation in surplus-producing economic activity needs to be put into proper quantitative perspective. Measured in various ways, enterprise by nonprofit organizations is not a new phenomenon of major proportions that should be viewed with great alarm:

First, nonprofits have engaged in such activity for a long time; we are not seeing anything qualitatively different now from what has previously transpired. Girl Scout Cookies, church bake sales, thriftshops, and a long list of other such activities, go back a long way (see Crimmins and Keil). What we are seeing now is an intensified interest in an old strategy of raising funds. Thus, prohibiting or substantially restricting such activity by tax-exempt organizations would be a radical departure from conventional practice.

Second, venture income represents a small part of nonprofits' earned income and an even smaller part of their overall revenue base. Most earned income by nonprofits comes from charging fees for services at the heart of a nonprofit's mission. For example, fee-for-service income represents about 30% of the income of nonprofit human service agencies (see De Vita and Salamon). However, recent studies indicate that commercial venture income _per se_ represents only 6 to 10 percent of organizational budgets, on average (see De Vita and Salamon and Yankey, Clark, and Ivery). Nonprofits' increased reliance on earned income over the last few years comes mostly from reductions in government support combined with increased use of fees for services already provided. Venture income is the more exotic but quantitatively less important component of that increase. Thus, actual competition with business in new areas of service is a small part of what is actually going on.

Third, most ventures by nonprofits take place in contexts or through activities closely related to the organization's mission, special resources or intrinsic capabilities. Like any other organization, a nonprofit will attempt to capitalize on its special knowledge, capacities, and assets - in economists' terms its comparative advantage. Thus, ventures include sale of reproductions of art works by museums or training seminars for segments of the general public offered by university faculty. Most nonprofit ventures do not extend far outside the organization's original portfolio of services or into areas traditionally associated with business. Often it is not clear if provision by a competing business would even be viable. In many cases, consumers recognize the charitable component or souvenir values of their purchases and probably would not patronize a commercial business to make the same purchase. For example, would consumers buy Museum of Art tee shirts from department stores, or should they be permitted to do so without royalties being paid to the Museum? In summary, not all venture activity by nonprofits represent head to head competition with business. I suspect most of it does not.

Given the contained scope of the issue, however, it is still important to consider whether nonprofits should be allowed to compete with business in areas where there is a serious threat of conflict, and if so, under what conditions. On this question I would like to make two key points:

(1) Conceptually, there is no reason why nonprofits should not be allowed to compete with business to earn profits, so long as the rules are, in some sense, "fair". What nonprofits do is plow their surpluses back into their service programs so as to carry out their primary missions more effectively. Businesses, on the other hand, use profits both to reinvest in the enterprise and to reward the providers of capital. Each set of uses is legitimate; they are simply different. Thus, it is not clear why profits for business should take priority over profits used in pursuit of the social purposes which nonprofits seek to address.

(2) If pursuit of profits by nonprofits and business are

considered equally legitimate then the question of fair play comes into discussion. In particular, what are the rules that will allow profits and nonprofits to compete on an equal basis? In this respect, it is important to look at all the parameters affecting competitive advantage of profits versus nonprofits. Exemption from corporate income taxation, postal benefits and other privileges need to be examined on the nonprofit side, but policies that work to the advantage of businesses, such as "set asides" for certain governmental contracts or guaranteed loans for small businesses, need also to be examined if the playing field is to be made truly level (see Wellford and Gallagher).

Aside from the issue of fair competition between profits and nonprofits, there is another way of looking at the issue of nonprofit pursuit of profitmaking ventures. In particular, allowing the pursuit of profits by nonprofits may be viewed as one alternative for addressing the fiscal needs of the nonprofit sector or the social needs which these organizations serve. In this perspective, it is clear that any public policy addressed to this issue will impose a cost burden on some segment of the economy or citizenry. The real question is thus, what is the fairest or least onerous way of shouldering this burden? Some kind of tax-based support would seem to be required, whether that be direct governmental expenditures, increased deductions for charitable contributions, or other alternatives. In this framework, tax-exemption for the venture income of nonprofits may be viewed as a tax-based source of support whose incidence appears to fall primarily on the business sector. Whether this is a desirable alternative depends on how the burdens of other alternatives fall. All public sources of support for the nonprofit sector will cost money and will be paid for by some constituency. *A priori*, it is not clear that tax-exemption for the venture income of nonprofits is any better or any worse than other means. An analysis of the alternatives would be a worthwhile research project, both to clarify the alternatives and to verify if indeed, the business sector is seriously negatively impacted by nonprofit venture activity. I know of no conclusive study of that issue to date.

The one serious concern that I do have about the effect of nonprofit venture activity has to do with the possibility of corruption of the sector itself. In particular, one worries about the danger of nonprofit organizations being diverted from their social missions by becoming preoccupied with the pursuit of surplus producing activity. This becomes an increasing risk as nonprofits face greater fiscal pressure and gear their attention to finding more creative ways of fundraising. Survival and fiscal integrity become dominant concerns and social goals may become neglected. Sociologists called this phenomenon "goal displacement" (see DiMaggio). A second concern is that as profitmaking activity becomes more the norm in nonprofit sector operations some bad apples may slip into the nonprofit barrel, i.e. there will be organizations that use the nonprofit form as a pretext for personal enrichment.

These are phenomena that need to be guarded against with appropriate policies and policing mechanisms such as the IRS administers. However, I do not see them as major problems or even incapable of solutions by nonprofit organizations themselves. I draw on some of my own research to support my feelings on this issue. I have done substantial fieldwork studying "entrepreneurial initiatives" of nonprofit organizations in the human services. I defined entrepreneurship broadly to include major programmatic initiatives such as setting up new organizations, or new programs within existing organizations, or bringing about major changes in the direction or organizational structure of an existing organization. In the dozens of detailed cases I documented, I found a variety of operant motivations, ranging from strong beliefs in causes and service to needy groups, to professional achievement, to interests in personal power and well-being (see Young). However, rarely, if ever, did I find material enrichment to be a dominant driving force in these endeavors. Nonprofit entrepreneurs are not necessarily selfless, but neither are they primarily driven by money. They have other values that drew them to work in the nonprofit sector, and they recognize that rewards in this sector differ from those in business. Obviously, abuses occur and scandals uncover those that violate sector norms. But the PTL and other such cases are not the tip of an iceberg. They are flies in an otherwise relatively clear soup that need to be dealt with with a swatter, not a sledgehammer.

The issue of goal displacement is more subtle, however. Individuals do get caught up in what they are doing, and if pressured into raising funds in creative ways may become preoccupied with this endeavor and lose sight of ultimate service goals. Some of my case studies appear to put the cart before the horse in terms of funding versus program development. But organizations in the sector are aware of this potential problem and some implicitly address it through better planning. In particular, the issue of goal displacement seems best approached by practicing some form of strategic planning wherein an organization consciously and regularly takes a look at its mission and formulates and implements a strategy to achieve that mission (see United Way of America). Within such a framework, enterprise activity will be evaluated in terms of how it contributes to the overall work of the organization, not as an activity in its own right. The bottom line for a nonprofit organization is not how much money it makes but how effectively it accomplishes its service goals. Money is obviously a part of that but by no means its entirety. Because the articulation and measurement of service goals are often difficult, the work of the nonprofit manager is frequently more subtle and complex than that of his business sector counterpart. If the nonprofit manager sometimes slips into the bottom line philosophy of a business it is understandable, but also correctable through an adequate planning framework. By and large, as demonstrated by the research of Edward Skloot and others who provide consultation for nonprofits engaging in commercial activities, the ventures which nonprofits have undertaken are generally closely related to organizational missions or contribute to those missions in ways that have been thought through beforehand (see Skloot).

In summary, the thrust of my observations would not support a major change in the current regime for maintaining tax-exempt status or taxing the profits of nonprofit-based commercial ventures. These ventures ought to be seen as a natural part of nonprofit organization operations and maintained within bounds that ensure that such activity properly contributes to the legitimate mission of the organization. The present distinction between related and unrelated business income makes this judgement imperfectly, however. The earlier "destination" standard applied by the IRS prior to 1950 seems closer in spirit to what is needed (see Lifset). Profitmaking ventures that are not inexorably bound to the existing services of a nonprofit organization may still contribute to its mission by providing resources. In this case, the Congress needs to judge whether such revenue should be left untaxed in order to support the work of nonprofits, or if it should be taxed in order to be fair to business. In the latter case, however, Congress should address the larger issue of where support for the nonprofit sector is to come from, given the present limits on charitable giving and direct governmental funding.

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Statement to the Committee on Small Business,
United States House of Representatives, June 28, 1988

I. NONPROFITS AND BUSINESSES IN HISTORICAL PERSPECTIVE

Debate over commercial activities by nonprofit firms is hardly new. As early as the 1920s, the federal government began to express its concern about the tax treatment of unrelated business income.[1] The tax code revisions of the 1940s moved towards tightening provisions regarding the ownership of businesses by nonprofits and the taxibility of commercial income.[2] Persuaded that tax exemption gave nonprofits unfair competitive advantages over taxable businesses and concerned about the loss of tax revenue, Congress in its 1950 revision of the internal revenue code finally decided that certain kinds of earnings by nonprofits should be taxable.[3]

These concerns have been rekindled over the past decade, as declines in giving, federal spending cutbacks, and increasing demands for services have forced nonprofit, tax exempt, charitable organizations to turn to user fees and commercial activities to generate revenue. Pressured by segments of the small business community, legislators and jurists, have again begun to weigh the fairness of such activities carried out by organizations enjoying special tax privileges.

While the policy debate has focused on contemporary dimensions of for-profit/nonprofit competition, the views of those concerned have been shaped by prescriptive historical assumptions about the nature of charitable and business enterprise and the kinds of activities appropriate to each. I would like to suggest that these assumptions have been largely inaccurate and that efforts to restrict commercial activities by nonprofits have been based on fundamental misunderstandings of how charities have traditionally supported themselves in the United States and about their relationship to for-profit enterprise.

To begin with, most contemporary commentators appear to assume that there are well-established and clearly drawn boundaries between public, private, for-profit and nonprofit activity. To the limited extent that this is true, such clarity -- or, rather, wished-for clarity -- is characteristic only of the past forty years or so and is largely a product of the efforts of federal regulators and economic planners. There is increasing doubt that sectoring the economy is any more than a scholastic exercise, as it becomes increasingly clear that relations between government, business, and nonprofit institutions are far more characterized by interpenetration and interaction than by any clearly defined or enduring division of the social task between them.[4]

How have Americans traditionally divided social and economic responsibilities? For the first two centuries of settlement, corporations -- for-profit and non-profit -- were regarded under the law as essentially public enterprises, through which the state delegated its authority to bodies of individuals to do the public's business.[5] Legislatures reserved the right to alter or suspend corporate charters at will, to divert their revenues and restrict their rate of return, to oversee their activities, and to place public representatives on their governing boards.[6] This interpenetration of public and private spheres was universal: business and charitable corporations were subject to the same kinds of oversight and supervision.

With the Dartmouth College Case (1819), all this changed. The Supreme Court redefined corporations as private contracts between individuals which were constitutionally protected from government interference.[7] Though we can date the formal distinction of public and private sectors from this point, in practice, public agencies and private nonprofit and for-profit corporations remained largely undifferentiated -- not only from a formal legal standpoint, but also in terms of the kinds of goods and services they produced and their sources of revenue. At this point it is worth citing some examples of this lack of differentiation:

*although American commercial banking dates from 1780 -- and by the 1820s, hundreds of banks were in operation --, personal loans and mortgages remained a major source of investment income for most charitable enterprises in the Northeast. Though theoretically in competition with the banks, at no point did they regard the activities of colleges and hospitals as providers of credit as unfairly competitive, nor did businesses regard the tax exempt status of these institutions as constituting an unfair competitive advantage. Indeed, bank officers frequently borrowed from such institutions as Harvard and the Massachusetts General Hospital.[8] The shift away from such competitive activities occurred only in the 1850s, with the development of stable securities markets.

*Large-scale "non-business related activity" by early charities was not uncommon. From the early 1600s, Harvard was granted monopoly rights to operate the Charlestown Ferry.[9] In the 1820s, the officers of the Massachusetts General Hospital established one of the nation's earliest trust companies, the Massachusetts Hospital Life Insurance Company, which not only sold life insurance and annuities, but also engaged in large-scale commercial lending.[10] But the 1840s, MHLI had become the largest single source of investment capital in the United States. At no time, however, was this commercial activity regarded as inappropriate to a charity or viewed as unfair competition to for-profit insurance and banking companies.

*Even in the Midwest, where private charities were regarded with profound suspicion by many legislators and jurists, the primary source of financial support for the early colleges and academies was the sale and rental of land. These commercial activities were unrelated to the colleges' charter purposes of teaching and learning and carried on in competition with private owners of real property. The latter found nothing to complain of in this arrangement -- though the colleges felt that legislative restrictions on prices and rental fees restricted their ability to compete effectively in the marketplace. (The legislatures, hoping to maximize the colleges' incomes had set rates artificially high).[11]

Courts and legislatures in nineteenth century America not only permitted tax exempt charities to carry on unrestricted commercial activities -- often in competition with for-profit providers of the same services --, but also actively encouraged such ventures. One of the most common forms of support for charitable enterprises was the legislatively-authorized lottery. At a time when lotteries were also being used to finance the construction of railroads, canals, and manufacturing enterprises, this placed colleges, churches, and academies in direct competition for-profits for ticket sales. But, once again, no one saw this competition as unfair, the commercial activity as inappropriate, or tax exemption as conferring any particular advantage to the charities.

We have tended to view nonprofit/for-profit competition in terms of the advantages that charities may have enjoyed because of their tax-exempt status. But it may also be useful to examine the competition that non-profits faced from businesses offering the same services but enjoying the advantage of being able to attract investors motivated by profits. Though we are in the habit of thinking of education, health-care, and cultural activity as being intrinsic to the non-profit sector, until the twentieth century, this was largely not the case. Throughout the nineteenth century in all these areas public, proprietary, and nonprofit enterprises competed freely and fiercely.

*In the fine arts, such notable painters as Washington Alston financed major works through the sale of stock. His paintings were exhibited by consortia of businessmen whose return on their investments came from admission fees. Such for-profit enterprises competed with tax exempt galleries like that operated by the Boston Atheneum.[12]

*Primary and secondary education in most cities was provided by public, proprietary, and private tax-exempt institutions, all of which vied for students. In Boston of the 1850s, for example, students could choose between such proprietary entities as "Mr. Noble's" or "Mr. Dixwell's," schools run for profit, charitable institutions like Hopkins Grammar, and public schools, including Boston Latin, which were supported by tax revenues.[13]

*The performing arts showed a similar diversity. Though the cultural life of mid-nineteenth century Boston was dominated by entrepreneurs like Gottlieb Graupner, who not only organized performances, but also sold sheet music and instruments, theatrical, choral, and orchestral performances also were offered by such tax-exempt groups as the Harvard-affiliated Pierian Sodality and Harvard Musical Association, as well as clubs like the Handel and Haydn Society.[14]

Why were Americans of the nineteenth century -- citizens well-known to be acutely sensitive to encroachments on their liberties -- willing to permit "privileged" tax exempt organizations to compete freely with proprietary enterprises in the domains of culture and commerce? The answer is two-fold. First, they seem to have perceived the relationship between for-profits and nonprofits as synergistic in creating markets for their products -- be those products musical, educational, or commercial; they accepted the idea that each benefited from the actions of others. Second, citizens understood that the greatest threat to liberty was government intervention in the affairs of private voluntary associations. To be sure, they acknowledged that tax-exemption and the ability to accumulate endowments conferred privileges to charitable enterprises, but they also understood that these advantages were off-set by the limitations of charitable status: charities were, in theory at least, accountable to the state; their funds and their activities were subject to a far greater degrees of stakeholder (member) oversight than those of sole proprietorships, family firms, and corporations; they could not attract investors through sales of stock -- they could only appeal for donations, bequests, or patronage; the funds and activities of charitable organizations were limited to their charter purposes -- they could not, as for-profits could, shift their foci to more remunerative fields without cumbersome legislative and judicial proceedings.

In sum, Americans of the nineteenth century understood that various forms of organization -- charitable/tax exempt corporations, unincorporated voluntary associations, for-profit corporations, sole proprietorships, partnerships -- carried distinctive advantages and liabilities. The choices among organizational vehicles should, they believed, be left to the citizens who created and patronized organizations, not to government regulators. Finally, Americans of the nineteenth century understood that a genuinely free marketplace required the participation of all kinds of players, public and private, for-profit and nonprofit: government offered tax privileges and subsidies to for-profit businesses as well as to nonprofit associations; but, most important of all, while willing to help both, it let each find its own way with as little interference as possible.

In conclusion, it is worth recalling that Alexis De Tocqueville's famous statement about the uniquely American drive to form voluntary associations was not restricted to charity, but referred to commercial and manufacturing companies as well.[15] In a democracy, Tocqueville believed, citizens were powerless unless they learned to voluntarily help one another, combining their energies and resources to common ends, whatever those ends might be. Restricting the right of association, whether for commercial or for charitable purposes -- even if done in the name of "the public interest" or "fairness" -- would, in this view, fundamentally endanger our liberty.

II. CONTEMPORARY IMPLICATIONS

What does the nineteenth century world of Alexis De Tocqueville have to do with the concerns of the Committee on Small Business in the current hearings? A great deal, I would argue, both in terms of substantial similarities and in terms of policy implications. My colleagues and I have been asked to address four issues:

1. Do the tax exemptions and other benefits granted to nonprofit organizations provide a competitive advantage in the marketplace?
2. Why have income producing activities increased in the nonprofit sector?
3. In what industries and types of activities have small businesses been most affected by "unfair" competition from government and nonprofit organizations?
4. What policy solutions exist to address the problem of nonprofit and government competition with small businesses?

Past experience sheds important light on each of these issues.

First, as to tax exemptions and other privileges: it is true that nonprofit status confers on organizations certain apparent advantages. Under state and federal statutes these include:

*exemption of corporate income from taxation (subject to certain restrictions on "non-core-related earnings" and investment income to organizations classified as private charities);

*exemption under state and municipal statutes from taxation on real property;

*the ability to hold property in trust in perpetuity;

- the ability of citizens giving and bequeathing property to deduct some portion of the value of their gifts and bequests from their tax obligations to government.

With the exception of the last, which came into being only with the creation of progressive income and estate taxation early in this century, these "advantages" were the same enjoyed by charitable institutions in Tocqueville's time. Even deductability is not as new as commonly thought, however. Though income taxation in the modern sense was unknown in early America, many states levied a "faculty tax" based on the estimated value of a trade or profession.[16] Ministers, teachers, college professors, and certain other classes of individuals were exempt from faculty taxes, as well as those on polls and real property -- an advantage that in some way resembles the contemporary situation of deductability.

Debate over the fairness of taxation is as old as democracy itself. The unfairness of British colonial tax policies led, as we all know, to our Revolution. And Americans continued to quarrel about the fairness of the tax system even under their own government. It is telling, however, that objections to "privileges" extended to charities and to employees of charitable organizations were uncommon. When they arose at all, it was when they were dispensed unevenly -- as when, for example, certain states extended them only to established churches and their ministers or colleges maintained by those ecclesiastical establishments. The faculty tax -- the early American equivalent of income taxation -- did arouse major opposition but not because of the exemption of ministers and others, but because of the intrinsic difficulty of estimating the value of any trade or profession. In most states the tax had been dropped by mid-century.

As has been noted earlier, businesses, nonprofits, and governments in nineteenth century America frequently offered the same or similar services to consumers and citizens. Government and charitable enterprises enjoyed the "advantages" of tax exemption and some form of deductability, proprietary businesses did not. The effects of this unfettered and unregulated competition are well-known: the marketplace, commercial and cultural, flourished; American industry, like the American arts, became noted for their extraordinary diversity, variety, and innovativeness.

Even at the beginning of the twentieth century, as monopolistic trusts emerged to dominate core industries and some private universities and foundations became multi-million dollar corporations (thanks in large part to the generosity of the trust-makers), the universe of organizations, for-profit and nonprofit, retained its incredible vitality. Just as huge industrial firms, hampered by internal inflexibilities, spun off newer, smaller, entrepreneurial firms -- which in turn created whole new industries --, so the large nonprofits, usually dominated by the wealthy, led to the creation of a myriad of nonprofits more responsive to the needs of particular constituencies (the Catholic and Jewish schools, hospitals, and charities exemplify this trend).

It is true that in certain areas of activity, particularly education and culture, nonprofits did come to dominate markets. By 1900, for example, most universities, art museums, and symphony orchestras were either public or nonprofit entities. But this, I would argue, was less a function of the "advantages" conferred by tax exemption than a matter of market segmentation. As the range of educational and cultural products became increasingly specialized, taxed and untaxed institutional actors by their own free choices chose to concentrate in certain areas of endeavor. In certain areas, such as vocational education and "popular" music and theater, proprietary firms remained -- and in many cases still remain -- the dominant actors. In professional education and "classical" music and theater, nonprofit firms became dominant. At no point, however, were for-profit actors barred from higher education or from providing high culture. Indeed, in the field of music, commercial broadcasters like NBC remained major producers of classical music, maintaining fully staffed symphony orchestras conducted by world-class maestros like Arturo Toscannini. (When NBC went out of the classical music business, it did so not because of unfair competition from tax exempt symphony orchestras, but because its assessment of changing public tastes led it to decide that its air time could be used more profitably). The division of markets between for-profit and nonprofit entities was a matter of free choice on the part of consumers and investors, not a product of intrinsic advantages enjoyed by one or the other.

To conclude my response to the Committee's first concern, history suggests that "tax exemptions and other benefits" have not provided significant advantages in the marketplace to nonprofit and government providers of goods and services. Unlike nonprofits, for-profits have been free to move from product to product and from market to market in search of the highest rate of return for investors; their access to capital -- through sales of stocks and bonds and through institutional borrowing -- is infinitely greater. Nonprofits on the other hand, are hampered by the fact that their supposed privileges have been accompanied by formal charter instruments, statutory requirements, and constituencies that have locked them into obligations, regardless of their potential to yield revenue. These same "advantages" also severely restrict their access to capital, if anything constituting a competitive disadvantage.

This leads to the Committee's second question, which bears on the reasons for growth of income producing activities by nonprofits. As earlier suggested, in the past nonprofit revenue sources have been enormously diverse: exclusive reliance on donations and endowment income has been the exception rather than the rule; substantial involvement in commercial activity has been typical rather than unusual. While it is true that commercial activity by nonprofits has increased over the past two decades, this is, taking the long-term view, a natural response to changes in their economic environment, in particular the diminution of federal expenditures. If past experience is any guide, there is nothing particularly alarming about these commercial activities, despite claims that they corrupt the mission of charity and provide unfair competition with business.

As to the Committee's question about industries and types of activities in which nonprofits compete unfairly with nonprofits: I cannot think of a single area where, over the long term, this has really occurred. The tables provided by the SBA detailing the division of nursing home, day care, post-secondary school, and research and development activities between for-profit, nonprofit, and government entities suggests that, while the burden is not always evenly spread, significant opportunities exist in all areas for all types of enterprises.[17] Though the report uses language suggesting that for-profits are threatened by entry of nonprofit firms, I do not find the examples provided persuasive. Couldn't one just as well argue that nonprofits were threatened by the entry of government agencies or business firms?

This leads to the fourth issue that concerns the Committee: the policy solutions to the problem of nonprofit and government competition with for-profit businesses. Given the long history of competition between the three types of enterprise and the abundant evidence that all three continue not only to flourish but also to significantly complement one another, I suspect that the best policy is a "hands-off" policy.

Once again, in this regard the historical record is a valuable teacher. In the early years of this century, small businessmen attempted to persuade the courts and the Congress to prevent the sale of nationally advertised brand name products, claiming that such products presented unfair competition to retailers. The eminent Justice Brandeis, a supporter of this movement, argued that

> the nationally advertised branded goods make the retailer practically an automatic machine, instead of an expert to whom the consumer pays, in profits, compensation for expert services and trustworthiness. . . . In a large part of the field there is no social justification for the national widespread market for the trademarked articles.[18]

Brandeis feared that chainstores and mass-produced nationally marketed products would eliminate the small businessman -- the family grocery, the corner druggist, the hometown hardware store -- and that, as in many heavy industrial sectors, trusts and monopolies would displace independent producers.

Brandeis's heart was in the right place. His sympathy with the plight of small businessmen at the mercy of vast impersonal enterprises was commendable. It is too bad that his concerns did not extend to consumers who had to pay the artificially high prices that resulted from so-called "fair trade" legislation. Consumers might be, as Brandeis supposed, "servile, self-indulgent, indolent, and ignorant."[19] But their needs also varied: some are happy with what the chain stores offered; others, prefer to buy other kinds of products in others kinds of settings. Is it the place of government, acting in behalf of some special interest group, to decided where each can buy?

In fact, the historical record has proven Brandeis and the advocates of "fair trade" legislation wrong. Not only have national chains and brand name products proven to be of immeasurable benefit to consumers, creating efficiencies of production and distribution that have enabled all to share in America's bounty, but small retailers have remained a flourishing and important part of the distribution network. In fact, it can be argued that the rise of national businesses, while foreclosing opportunities for small businessmen in certain areas, opened them in others by creating vast new markets for specialty goods and services. The lesson of efforts to promote "fair trade" in business is plain: when governments attempt to regulate competition, they strike at consumer preference, which is the core of a market economy.

In connection with this, it is worth recalling that some states and cities in the Progressive Era attempted to do politically what advocates of "fair trade" were doing economically. In Pennsylvania, cities adopting the commission form of government were required to permit representatives of all organized political parties representation on municipal bodies.[20] Thus, by legislative fiat, the Socialists were given a strong voice in the governments of cities where they had never succeeded in polling any great number of votes. It was an interesting experiment in non-partisanship, but it was no fairer to to the rights of the voters of the Commonwealth than "fair trade" legislation has been to American consumers.

The current efforts to restrict commercial activity by nonprofits is another manifestation of the largely discredited effort by government to mandate "fair trade." As such, it shows contempt for consumers and their interests, indifference to the historical record, and an astonishing solicitude for for groups which have placed their own desire for special privileges over the greater good of a free market economy.

AUTHOR'S NOTE: I wish to give particular thanks to Reid Lifset, a student at Yale's management school, for calling my attention to the "fairness" issue. I call the Committee's attention to his fine paper, "Cash Cows and Sacred Cows: Commercial Activities in the Nonprofit Sector," which was presented at the 1988 Independent Sector Research Forum.

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WORKING DRAFT

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CASH COWS AND SACRED COWS: COMMERCIAL ACTIVITIES IN THE NONPROFIT SECTOR

by

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We will go into any business but the oldest.

-- Frank Mankiewicz, announcing National Public Radio's intention to pursue for-profit business ventures to offset federal budget cuts.

The pursuit of commercial revenue by nonprofit organizations is a much discussed if not uniformly lauded activity within the philanthropic and public policy worlds. Managers of nonprofit organizations seek sources of reliable and abundant funds -- cash cows[1] -- that will replace dwindling government funding so that they can devote their full attention and resources to the organizations' central goals. At the same time, they want to maintain the philanthropic character of their organizations and the economic perquisites that accompany that character: they want to remain sacred cows and preserve the donative support that they receive from the public and the tax exemptions that they obtain from government.

Commercial activity appears to blur the distinction between business and nonprofit realms. To the general public that equates nonprofit organizations with charity, commercial activity is at least incongruous, if not inappropriate. To the scholar attempting to discover the basis of the division of labor between the nonprofit, government and business sectors, the pursuit of earned income adds a layer complexity to the requisite analysis.

Most of the published examinations of this topic are confined to prescriptions of managerial how-to's, policy analyses of the equity of competition between nonprofit organizations and for-profit firms and considerations of whether or not commercial activities represent a viable source of funding for nonprofit organizations. Little of a theoretical nature has been written which examines the role of this activity from an economic or political perspective. The scholarly literature that attempts to explain why some services are supplied by conventional businesses organizations, some by government bureaucracies and others by the nonprofit organizations has not focussed on commercial activities.

In this paper I examine the existing models of the nonprofit sector to see how well they account for the apparent anomaly of commercial activity. I argue that the models best equipped to explain commercial activity are those which emphasize the cross-subsidizing character of nonprofit activity (i.e., the use of revenues from one activity to support another). However, I find that the role of politics needs greater emphasis both at the organizational and sectoral level if the current models are to be successful.

In a sense this paper only amends and reorders portions of the existing theories of nonprofit organizations. It is an argument that political factors -- never entirely absent from discussions of nonprofits -- are at the core, rather than the periphery of what nonprofits are about. In other words, nonprofits are not well characterized as service organizations unimportantly different from their for-profit analogues.

With respect to commercial activities, the political character of nonprofits has three dimensions: (i) the ideologically-driven behavior of nonprofits at the organizational level that generates the "mission-oriented" character of many nonprofits, (ii) the impact of macro-political phenomena such as changes in national policy and institutions on the incentives and constraints facing individual organizations and (iii) the efforts of nonprofits to influence policy bearing on them.

I highlight the political factors because the dominant approach to the analysis of nonprofit organizations -- economic modeling -- underemphasizes this dimension of the sector. This is not entirely accidental. Economic analysis views markets and economic exchange as normatively, substantively and methodologically prior. That is, normatively, markets are, *ceteris paribus*, superior forms of social organization. Substantively, markets are seen to be the predominant form of social organization and finally, methodologically, institutions and social interaction are thought to be most productively analyzed as if they were economic transactions. As such, it is not surprising that economic models view nonmarket institutions as residual entities: nonprofits fill in where the market fails. Similarly, politics is of concern where economic factors are insufficient explanation.

I began my analysis with a simple taxonomy of nonprofit commercial activities. I then outline some of the economic models of nonprofit organizations and examine the extent to which they capture the role of commercial activities. I discuss the role of politics in theories of political economy and of the nonprofit sector. I show how commercial activities are best understood against the background of changing national policy. I conclude by discussing the implications of my recasting of nonprofit theories for public policy.

Commercial Activities

Broadly speaking, there are three categories of commercial activities: unrelated business activities, fees-for-services and related commercial activities.

Unrelated business activities -- The goal of these activities is unrelated to the basic mission of the nonprofit. The key purpose is the subsidization of the basic mission through the pursuit of profits in the market. While unrelated business activities are not associated with the direct accomplishment of the mission of the nonprofit, they may be intimately related to its particular competencies. That is, nonprofits will often choose business ventures that exploit their organizational expertise or piggyback on their existing physical capital (Nielson 1986). For example, if a nonprofit organization has facilities that go unused during certain time periods, those facilities may be used to generate revenue. The off-peak use does not further the mission of the nonprofit organization, but it can be an efficient use of those facilities.

Fees-for-services -- The services in these instances are mission services, but unlike classic charities,[2] the recipients of the services are also the source of financial support. Many traditional nonprofit organizations charge for their basic services and more and more nonprofits are beginning to move in this direction. Income from fees for services is sometimes labeled program service fees.[3] University tuition and fees for psychological counseling or job training fit in this category.

Related commercial activities -- These activities are the source of much of the current political controversy between nonprofit organizations and small business, especially as it regards the tax code. They are services which accomplish auxiliary purposes of a nonprofit organizations; typically, related commercial activities are performed to serve the various constituencies of a nonprofit organization. These sorts of activities range from university-operated laundries to museum gift shops to the YMCA's health clubs.

Note that Hansmann (1980) has developed a nomenclature for nonprofits that should not be confused here. He labels nonprofit organizations that receive most of their funding through contributions as donative nonprofits and those that receive most of their funding through fees-for-services as commercial nonprofits. I use commercial *activities* to designate a broader group of nondonative financing sources but follow his terminology when referring to nonprofit *organizations*.

Nonprofit organizations can perform their commercial activities either through an arms-length subsidiary or directly under the auspices of the nonprofit *itself*. *Frequently, entirely unrelated* business activities are performed in subsidiaries. Clearly, fees-for-services take place without the establishment of a subsidiary because the services constitute the very mission of the nonprofit.

Economic Theories of Nonprofit Organizations

For those that ponder the proper boundary between the public and the private domains, nonprofit organizations stand as an anomaly: they are private organizations explicitly performing public tasks. This anomaly attracts the interest of economists and they have developed most of the synoptic analyses of the nonprofit sector. They are intrigued and puzzled by the existence of non-business, non-governmental organizations operating in the economy. Their efforts to analyze nonprofit organizations using neoclassical microeconomics places them squarely in the midst of debates in political economy. In bringing their disciplinary tools to bear on nonprofit organizations, they are explicitly characterizing as economic entities what many people would consider to be nonmarket institutions.

Economic Models Applicable to Commercial Activities. The theories developed by economists to explain nonprofit organizations are roughly of two types: those that seek to explain the role that such organizations play in the economy and society; and those that seek to identify and account for the distinctive types of behavior in which such organizations engage (Hansmann 1987). Some economists describe these two types of theories as addressing the demand for and supply of nonprofit organizations, respectively.

Among the theories that try to explain the social role of nonprofits, a dominant approach is that of contract failure. The major proponent of contract failure theory is Henry Hansmann. He argues that:

> ...nonprofits arise in situations in which, owing either to the circumstances under which a service is purchased or consumed, or to the nature of the service itself, consumers feel themselves incapable of accurately evaluating the quantity or quality of the service that a firm produces for them (1987, 29).

Because nonprofit organizations face a nondistribution constraint, that is, the prohibition on the distribution of net earnings to individuals that formally control exercise control over the organization, they are appropriately structured to provide such services. A for-profit firm has both the opportunity and incentive to exploit the customer in these circumstances. Because of the nondistribution constraint, a nonprofit organization lacks the analogous opportunity.

According to Hansmann, a consumer or "patron" of nonprofit services is the donor in the case of a donative nonprofit, and the customer in the case of a commercial nonprofit. The donor in making a contribution to a nonprofit organizations, in effect, purchases goods or services for a third party, the beneficiary.

In applying the notion of contract failure to commercial nonprofits, Hansmann cites three factors which might contribute to failure were it not for the nondistribution constraint. First, the service might be complex and difficult to evaluate. Second, tho service user may not be the service purchaser -- as with all donative nonprofits, the commercial nonprofit in this case is supplying a service for third party purchase. Finally, the services may be continuing and long-term with the result that the costs of switching providers ("exit") and thus disciplining them is high.

Note that according to the contract failure theory, the nondistribution constraint resolves problems of market failure due to asymmetric information for both donation and fees-for-services. The implication is that commercial nonprofits providing services on a fee basis are not any less legitimately nonprofit than traditional donative nonprofit organizations. Thus, Hansmann's theory readily accommodates one of the three sorts of commercial activity under consideration in this paper. It does not provide as ready an explanation for cash cows.

James (1982) offers a sophisticated analysis of the behavior of nonprofits that is compatible with Hansmann's theory.[4] She characterizes nonprofit organizations as consumer-producer hybrids. In this model, nonprofits engage in a variety of activities, each of which has a different utility and profitability to the organization. The activities fall into three combinations of utility and profitability. Some activities yield positive marginal utility, but negative profit to the organization. They are deficit-producing. A second class have negative utility but produce a profit. Finally, some activities also yield profit but are of neutral utility. The first category is the set of activities which form the crux of nonprofit charitable endeavor -- those services which cannot support themselves in the marketplace. James describes them as implicit consumption, that is, the nonprofit organization's raison d'etre is to perform these activities because the members of the organization enjoy the work, obtain social legitimacy or kudos for their efforts or simply satisfy an altruistic impulse.

The two other types of activity -- which are profitable -- cross-subsidize the implicit consumption. Those activities with negative marginal utility will decline under a variety of circumstances; basically, any time the nonprofit organization can find other means to support its loss-making activities. The cross-subsidizing activities with neutral utility, however, will continue with less sensitivity to changes in the behavior of the first two types of activity.

Rose-Ackerman (1987) elaborates a model which by focusing on the relationship between donors and managers of nonprofits, provides the framework for showing how nonprofit managers may choose to pursue commercial activities as against other funding sources. She suggests that the managers are more interested in the choice of product mix that their organizations produce than are their for-profit counterparts. Nonprofit managers are not as directly responsive to their clientele as for-profit managers in part because of the selective recruitment of certain types of people into such positions in nonprofits: ideologically-oriented professionals gravitate to these positions.

Rose-Ackerman argues that her model explains why nonprofits seek to replace revenue losses caused by government cutbacks. If nonprofit managers were not ideologically motivated, that is, if they simply maximized revenue or output rather than some dimension of service quality, they would always be seeking new revenue sources. The criterion for their search in that case would be the marginal productivity of fundraising. If, on the other hand, service quality is important, fundraising or output may not be maximized if it leads to a decrease in quality.

The character of the output will respond to the character of the revenue: if an unconstrained revenue source declines in availability, the nonprofit will be forced to shift to one with more strings attached. The service mix will change as a result. Rose-Ackerman views government funds as a revenue source without strings attached. She therefore views the funding environment of the 1980s as one in which nonprofits face more constrained funding sources.

This model suggests that commercial revenue will be pursued when (i) its pursuit is relatively lucrative (i.e., high marginal return) and (ii) it is relatively less constraining on the output the manager seeks to produce than other sources. In the face of low but positive marginal return, managers may choose to devote their resources to service quality instead of pursuit of revenue. This model can be viewed as an elaboration of the utility/profitability model of James. The dependency focus in Rose-Ackerman's work arises because her model emphasizes the sensitivity of service mix to the character of funding sources.

It is interesting to note that in the models of nonprofit managerial behavior suggested by James and by Rose-Ackerman, the activities which the nonprofit organization uses to subsidize its deficit producing activities need not be for-profit ventures. For instance, the set of examples that James uses to illustrate her model includes *both* situations where the subsidizing activity is unrelated to the organization's mission and instances where the subsidizing activity is centrally and uncontroversially related to the organization's mission. An example of the latter is James's analysis of the relationship of undergraduate to graduate education in universities where she argues that undergraduate education produces a surplus which supports the cost of graduate education (1982, 11-12). Note that the subsidizing activity is a conventional, nonbusiness source of income in this case. The commercial character of the subsidizing activity is irrelevant to these models.

The behavioral, supply-oriented models developed by James and Rose-Ackerman are not incompatible with the contract failure and other demand/role models but they are different in emphasis. The supply models ask how nonprofit organizations differ in behavior from other sorts of organizations and how legal and other constraints stimulate those distinctive behaviors. By asking what goals the operators of nonprofit organizations pursue -- what they maximize -- the supply models highlight negative and positive characteristics of nonprofits. On the one hand, supply models stress the potential productive inefficiencies of nonprofits insofar as nonprofits are insulated from the market and therefore allow nonprofit operators to maximize perquisites, budgets, output, status or other ends may not be correlated with efficiency or public goals. On the other hand, the cross-subsidization models which I have reviewed reveal the organizational means by voluntary redistribution is accomplished.

The demand models, in contrast, typically start with a larger unit of analysis, often focusing on sectoral differences. The demand models also differ in their treatment of commercial nonprofit organizations, that is, those nonprofits that charge fees-for-services. The demand models explain, and to a limited extent, legitimate the nonprofit status of such nonprofits as a response to market failure. In contrast, models based on cross-subsidization provide neither an account of why these sorts of organizations are nonprofit nor a normative rationale for their status and tax treatment.

Another way of viewing these differences is to say that the cross-subsidization models (potentially) put redistribution at the center of consideration whereas the contract failure models view redistribution simply as one preference exercised in the market. The cross-subsidizing behavior could be taken as a normative criterion for nonprofit status or at least for tax subsidy. It would then entail a critical stance towards nonprofits which rely wholely on fees-for-services because they provide no services needing subsidy. I discuss the normative question of commercial nonprofits in the context of the controversy over competition between small business and nonprofit organizations in the final section.

Allocative and Non-Allocative Exchange. In addition to the specific limitations that the various economic models face in accounting for commercial activities, there are broader difficulties that these models pose for the analysis of nonprofits and their cash cows.[8] The functional characterizations that Hansmann and James provide for nonprofit organizations transform those organizations into a species of market organization. It is that accomplishment that underlies the impression that the reader gets of the blush being removed from these organizations. To put it crudely, donations to CARE are just purchases of hunger relief. They are one among innumerable kinds of market transaction. The way to evaluate them, therefore, is in terms of their allocative efficiency.

The economic models discussed in this paper characterize nonprofits as allocative mechanisms. I think that it is clear that some nonprofits are redistributive mechanisms. The confusion here is analogous to conflating the allocative activities of the government (i.e., economic transactions viewed from the perspective of optimal use of resources or Pareto-efficiency) such as garbage collection with the redistributive ones (i.e., transactions viewed from the perspective of equity) such as progressive taxation or welfare services.

It may be legitimate to evaluate the allocative dimension of donative nonprofits but that is not the same as claiming that they exist to perform allocative functions. Consider Hansmann's characterization of donations as third party payments for goods provided to more or less irrelevant beneficiaries. For Hansmann, the important characteristic of the nonprofit is that it allows exchange to be made -- the donor exchanges money for the execution of charitable services -- with the reasonable assurance provided by the nondistribution constraint that the donation will not be pocketed. The beneficiary is virtually absent here. But suppose that we focus instead on the beneficiary by concentrating on the subsidized output of the organization. A donative nonprofit typically provides either less-than-market-price goods and services or zero-price goods and services. As James's model indicates, the conduct of a nonprofit can only be understood by placing its cross-subsidizing behavior, the behavior that is mostly likely to be redistributive, at the center of the model. While Hansmann's model is not set up to account for behavioral variation among nonprofit organizations, that difference in orientation does not vitiate the problem that it faces in even beginning to account for important changes in nonprofit behavior such as when a nonprofit begins to charge clients for services it previously provided for free.

Subsuming redistributive functions under allocative characterizations -- by making them a preference exercised through exchange by nonprofits -- obscures important political issues. The growth of for-profit activities among nonprofit organizations can be seen as a rise in the preponderance of cross-subsidization as a funding mechanism for the delivery of public services. Analysis of the sort that is suggested by James's model illuminates questions of market distortion through non-cost based pricing or of the fairness of cross-subsidization for the customer purchasing the subsidizing service. It is not conducive, however, to the examination of shifts in the structure of the welfare state of which this is clearly an important part.

More broadly, charity can be described as voluntary redistribution. Viewing nonprofits as allocative institutions effectively denies a place for altruism. While this approach seems more hard-nosed and realistic, it denies common sense perceptions that altruism is not simply the exercise of one preference among many. More importantly, it prevents the consideration of issues such as whether nonprofits are a means of inhibiting greater redistribution (e.g., coercively through governmental means). For example, the history of private foundations and philanthropy in the US is fraught with acrimonious debate over the legitimacy of the exercise of private power for public purposes (Simon 1978; Nielsen 1972; Ylvisaker 1987). Similarly, the very existence of corporate foundations raises questions of whether corporate and private philanthropy functions to provide reform in place of fundamental social transformation. The characterization of nonprofits as redistributive permits the connection of the study of nonprofits with that of positive and normative issues of distributional justice. Should redistribution be accomplished through private voluntary means? What are the implications of a major change in the nature of that private voluntary mechanism?

This is not to argue that nonprofits are primarily redistributive social mechanisms. Many types of nonprofits are not: their services do not shift resources from the more well off to the less well off. Arts organizations, such as operas and symphonies, have upper-middle class and upper class constituencies and trustees. Universities are viewed by many as functioning to socialize elites. Even many social welfare organizations such as mental health centers are not redistributive.[6]

Keeping redistributive issues in center of analysis of nonprofits has policy implications as well as theoretical importance. In the current controversy over competition between nonprofit organizations and small business, the justification of nonprofit commercial activity hinges on the legitimacy of nonprofit cross-subsidization. Characterizing cross-subsidization only as allocative hinders rather than helps the process of establishing normative standards for nonprofit behavior.

This problem is manifest in more concrete form in that neither James's nor Rose-Ackerman's model tells us why large-scale commercial activity did not occur prior to the 1980s. If, as James's model indicates, it is in the very nature of nonprofits to cross-subsidize internally, then why have they not always done so? Rose-Ackerman's model suggests that any revenue source may be left unexploited if the trade-off between constraint and funds is too unappealing. Absent some specification of nonprofit managers' preferences, this formulation becomes tautological: commercial revenues are not pursued because other funds were available or the commercial revenues were not worth the constraints on managerial prerogatives.

Politics, Policy and Nonprofit Commercial Activity

I want to argue in this section that politics and policy importantly shaped the macro-environment in which nonprofits evaluated their funding options. Neither cross-subsidization, cash cows nor nonprofits in general can be understood without bringing politics and policy into the story.

There are two different ways in which politics and policy shape nonprofit commercial activity. First, government policy can directly and/or deliberately shape the sectoral division of labor. I will review the recent theories of Salamon (1987) and James (1987) in which government-nonprofit relations are made a more central determinant of nonprofit roles. Second, government action taken for essentially unrelated reasons can affect intersectoral relationships.

The emphasis on politics and policy and the associated focus on the way in which government can structure behavior in society in often unintended ways is related to some arguments now being made by neo-statist political theorists. Neo-statists are interested, in the words of recent book, in Bringing the State Back In (Evans, Rueschemeyer and Skocpol 1985). Their program has two components. First, they argue that the state is frequently autonomous, that is, it is capable of formulating and pursuing goals that are not simply reflective of the demands and interests of social groups, classes or society (Evans, Rueschemeyer and Skocpol 1985, 9). It is not my intention to argue that the American state was or is crucially autonomous with respect to government policy on nonprofit organizations or cash cows.

Second, they propose that states be studied from a "Tocquevillian" perspective:[7]

> In this perspective, states matter not simply because of the goal-oriented activities of state officials. They matter because their organizational configurations, along with their overall patterns of activity, affect political culture, encourage some kinds of group formation and collective political actions (but not others), and make possible the raising of certain issues (but not others). ... When the effects of states are explored from the Tocquevillian point of view ... the investigator looks more macroscopically at the ways in which the structures and activities of states unintentionally influence formation of groups and the political capacities, ideas, and demands of various sectors of society (Evans, Rueschemeyer and Skocpol 1985, 21).

This aspect of the neostatist approach holds out the potential for explaining what nonprofits and their cash cows have in common in spite of the diversity of industries in which they operate. From this perspective, nonprofits and cash cows need not share functional characteristics in all times and all sectors. Instead, their commonality can grow in response to benefits bestowed or penalties threatened by the state (e.g., tax exemptions or its withdrawal). Organizations can consciously assume the nonprofit form in response to the incentives provided by the state. And those incentives can change over time as the larger political economy and specific government policies evolve. The government policies that so shape the development of nonprofits and cash cows need not be responses to market failure and therefore need not be driven by autonomous economic factors.

There is another way in which the state may be crucial to the analysis of nonprofit organizations. Most theories of the institutional division of labor start with the question: why not the market? The answer is typically one variant or another of market failure. While the characterization of certain goods and services as not being amenable to market provision because, say, they are public goods[8] may be transhistorical or transcultural, government and other institutions can play a crucial role in altering the environment in which the good is produced or consumed so that it may capable of being provided through marketplace means.

Karl Polanyi propounded a thesis related to this in The Great Transformation when he argued that the establishment of free wage labor markets in the 18th and 19th centuries was not a natural development but rather the result of protracted political struggle and deliberate institutional change (1944). By the same token, the character of goods and services may be altered by public policy so as to change the characteristics that make them less amenable to market provision.

Similarly, markets do not function where the consumers lack the income with which to make purchases. In order for their needs or demands to be met, they must be subsidized in some manner. The cross-subsidization that occurs within nonprofits is one way to remedy those needs. Government subsidy of providers is another. And direct government subsidy of the consumers is a third. The point here is that government has the potential for shifting sectoral assignments through changes in the methods of subsidization. While answering the question "why not the market?" is illuminating insofar as it tells us that some goods are not amenable to marketplace provision, it avoids the larger question of why the character of those goods evolve.

Theories of Nonprofit-Government Relations. Before turning to the discussion of the specific political phenomena that influenced nonprofit commercial activity, it is useful to look at the theories that model nonprofit-government relations. Salamon (1987) and James (1987) both argue for a revision of economic theories of the nonprofit sector which characterize the sector as a residual set of institutions arising as a result of the failure of either the market or the government to meet social needs.

Salamon maintains that nonprofits historically existed in partnership with government rather than in competition. He describes the respective roles of government and nonprofits as policy formulation and policy delivery and he adduces a variety of historical evidence to indicate that such a complementary relationship can be dated back to pre-revolutionary times in the United States (1987, 101). The evolution of the respective roles in public service has been from *provision by nonprofits to provision by government*.

The shift in responsibilities has arisen not in response to government or market failure as other theorists have claimed but in response to the inadequacies of nonprofit provision. Salamon labels such inadequacies voluntary failure and specifies four sorts of failure: philanthropic insufficiency, philanthropic particularism, philanthropic paternalism and philanthropic amateurism. He also discusses the strengths of nonprofits vis-a-vis governments thereby explaining the benefits gained by collaboration. But it is the account of the shift of provision from nonprofits to government that is interesting here because of its relative novelty among theorists of the nonprofit sector and because of its historical verisimilitude.

Salamon combines the explanation for the growing role of the state with the differentiated characterization of government and nonprofit roles to arrive at a theory that avoids ascribing a residual role to nonprofits. It is a theory that makes sense of the current character of nonprofit funding with its dependence on government funding and its surprising lack of donative support.[9]

Estelle James, in recent comparative international study of nonprofit sectors, has been led to amend the economic emphasis on nonprofit organizations as a response to market failure as well. Like Salamon, she finds differentiated roles for nonprofits and government: "whereas government is a substitute for NPOs [nonprofit organizations] in production, it is a complement in financing" (1987, 397).

James posits two variables which explain why certain services are provided by the private sector rather than government: excess demand and differentiated demand. The former occurs where citizens find certain (typically quasi-public) services underprovided by government and turn to private production to obtain those services. The second demand-side explanation, differentiated tastes, occurs where government production is constrained due to the differences in taste with regard to the kind rather the quantity of services. James specifies four conditions under which private sector production would grow:

> 1) peoples' preferences with respect to product variety are more heterogeneous and more intense, owing to deep-seated cultural (i.e., religious, linguistic, ethnic) differences;
> 2) this diversity is geographically dispersed so it cannot be accommodated by local government production;
> 3) government is constrained to choose a relatively uniform product; and
> 4) the dominant cultural group is not determined to impose its preferences on others; hence private production is a permissible way out. (1987, 402)

James then goes on to argue that private production typically occurs under nonprofit rather than for-profit auspices primarily because ideologically-motivated groups and individuals, especially those affiliated with organized religion, seek to maximize their adherents. The nonprofit form allows for behavior not compatible with profit maximization. For example, below cost provision of educational services attracts pupils and is only possible with an organizational form that is conducive to cross-subsidization. Other factors such as access to low cost labor, client trust and loyalty due to ideological affiliation and government subsidy secured through exercise of political power cement the advantage that the nonprofits have over for-profits in provision of the relevant services.

James explains government delegation and subsidization of nonprofit provision by the cost advantages obtained by using nonprofits which have access to low cost labor and multiple funding sources. She also argues that various social groups will want to control provision of certain services for ideological reasons (e.g., religious groups may want to control schooling because it is a means of socializing new members of the faith) and such groups may form coalitions to obtain the subsidies.

These two models place the nonprofit-government relationship in the center of theorizing about the nonprofit sector. Salamon's account with its greater verisimilitude turns the tables on the economists by posing the question: why not nonprofit organizations? His theory lacks a substantive theoretical discussion, however, of nonprofits versus for-profits. One could impute a market failure component similar to those used in the other models discussed in this paper with a Polanyian perspective: social services are not amenable to for-profit provision; why and how they become amenable to certain sorts of provision is importantly a function of government and nonprofit action.

James's model builds on her earlier analysis of cross-subsidization in that it relies on ideological components in the development of the supply of nonprofit services. In her older model this would be called organizational consumption. The later model is much more sophisticated in that it posits ideological interests on the part of consumers and it characterizes government as more than a competing multi-product nonprofit organization.

Against the background the economic and political theories of the nonprofit sector sketched above, I want to now review some of the concrete developments in national policy and in the nonprofit sector that have contributed to the emergence of increased commercial activity. The phenomena that I describe will evince a clear role for the impact of politics and policy on nonprofits and their cash cows.

Four political phenomena shape commercial activity of nonprofits:

1) government funding of nonprofit organizations and the resulting expansion of nonprofit sector and the incursion of for-profit firms into traditional nonprofit industries;
2) privatization and the contraction of the nonprofit sector;
3) tax policy; and
4) controversies over competition between business and nonprofits.

I will treat the first three phenomena in the remainder of this section and the fourth in the concluding section on policy implications.

Government Funding and Expansion of the Nonprofit Sector. Increases in government spending on social services (in the broadest sense of that term) had two very important impacts on the nonprofit sector and on the sectors' commercial activities. First, increases in government funding of nonprofits in the postwar period stimulated the growth of the nonprofit sector. New organizations were created in response to this stimulus and existing organizations expanded. When, several decades later, the Reagan Administration reduced that funding, the organizations threatened by those cut-backs sought new revenue sources to replace government funding. Commercial revenue was one source of alternative funding.

Second, in a variety of social and health care fields, the government initiated extensive third-party, voucher-type financial support of services in industries where nonprofits were active. In other words, the government gave individuals money with which to buy services from providers that were either nonprofit, for-profit or governmental institutions. The most notable of these programs is Medicare, the federal health insurance program for the aged. Client populations that previously had only been served through subsidized provision by nonprofits or the government could now be served by for-profit firms. The provider organization no longer needed to obtain and furnish the subsidies on behalf of the clientele; the clientele brought the subsidies with them. The result was that in a number of industries it was now profitable for conventional businesses to compete with traditional nonprofit social service and health care providers. Competition between nonprofits and business resulted. Political controversy followed.

The effects of increases in government funding, thus, produced political and economic repercussions that are central to the circumstances that shaped the pursuit of revenue by nonprofits in the 1980s.

Nonprofit organizations providing personal social services began to obtain a significant portion of their funding from the government in the 1960s. In particular, the 1967 amendments to the Social Security Act, which provided grants that matched triple the value of funds donated to nonprofit social service agencies increased both nonprofit reliance on government funding and the size of this portion of the nonprofit sector. Nonprofit social service agency reliance on government funding was further increased in 1974 when Title XX of the Social Security Act broadened the criteria for eligibility for receipt of personal social services (Kramer 1982).

Similarly, the Educational Television Facilities Program and the establishment of the Corporation for Public Broadcasting in the 1960s stimulated the growth of nonprofit broadcasting.

Public subsidy stimulated the growth of nonprofit health care providers in several ways. Direct funding of providers that served the poor just after World War II spurred nonprofit growth as did the system that replaced it: Medicare and Medicaid. These programs subsidized the patient directly and the provider indirectly by stimulating demand. As will be discussed below, this form of support also encouraged for-profit provision.

Some federal health care funding was designed specifically to stimulate the growth of nonprofit institutions. The Hospital Survey and Construction Act of 1946, known as the Hill-Burton Act , subsidized a variety of nonprofit and public health care facilities especially short term general hospitals (Marmor et. al. 1987, 226; Starr 1982, 348-351).

Privatization. Privatization has a double importance to the analysis of cash cows. As an empirical matter, withdrawal of government funding stimulated nonprofit commercial activity. As a theoretical and ideological matter, it signals an attempt to alter the institutional division of labor in American society. But it also exposed significant ignorance, even misunderstanding of the character of the nonprofit sector.

The proponents of privatization view nonprofits as an alternative to the state. Earlier, I discussed Salamon's theory of government-nonprofit partnership. His theory grows out of the findings of the Urban Institute's Nonprofit Sector Project which he directed. The Urban Institute has been studying the changing role of nonprofit organizations in the US and especially the relationships between these organizations and government in a large scale research project for the past 6 years.

The Urban Institute research captured a crucial characteristic of the situation posed by federal budget cuts for nonprofit organizations: they were getting caught in a squeeze. On the one hand, the government was explicitly looking to them to step in and provide those services which were being eliminated from the federal budget. This stimulated demand for nonprofit services. On the other, federal financial support for nonprofits was being reduced -- the supply of nonprofit services was thus being curtailed. Finally, the amount of the shortfall was much larger than could be expected to be met by increased donative support of nonprofits.

This research had two great strengths. First, it recognized as few other analyses of the sector had, that nonprofits received a significant portion of their funds from government and that federal budgets would have direct impact on them. Second, it quantified the magnitudes of the various impacts.

As of 1981, government was the largest source of funding for the sector constituting 41% of revenues. Of the ten subsectors that the project analyzed, six relied more on government revenue than more than all other sources combined and for eight subsectors government was the largest single source of revenue. In none was donative support the largest source of support.

Thus it is not surprising that the budget cuts in the period 1982-1986 produced revenue losses to nonprofit organizations (exclusive of Medicare and Medicaid) of approximately $23 billion below what would have existed had FY 1980 spending levels been maintained. That translates into an approximate annual loss of $4.6 billion dollars a year in "supply." In the same period, cuts in areas in which nonprofits are active have amounted to about $70 billion. This has generated the increased demand for service provision by nonprofits.

Private philanthropy was expected to make up the gap between supply and demand in the support of health, welfare, culture and the arts. The Urban Institute's research indicates that private giving was able to make up for some of the budget cuts but giving could not do the whole job. Charitable contributions made up for only 57% of the direct revenue losses sustained by nonprofits and only 7% of decrease in government spending in the areas of interest to nonprofits. Looking to the future the Urban Institute calculated that in order to offset the budget cuts that the administration has proposed for FY 1987-1989, private giving would have to grow at a rate of 700 to 800% higher than its peak rate in recent years to meet the service gap. To offset the direct revenue losses, giving would have to grow at a rate 200% to 300% higher than its recent peak rate.

This combination of increased demand, decreased federal revenue and limited growth in private giving is compounded by the recent revision of the tax laws. The new flatter tax rates decrease the economic incentives for charitable giving. At the same time, the abolition of the charitable deduction for nonitemizers and the increase in the floor for itemizers further reduces tax incentives for giving. Nonprofits have been getting squeezed all around.

The Urban Institute's findings demonstrate that nonprofits had relied on government support and that cutbacks in that support put them in a position where they had great incentive to seek alternative sources of revenue. It is not surprising that this pressure lead many of them to pursue commercial revenue. Here it is important to note that it is not the "comparative advantages" of the respective sectors that generates the intersectoral division of labor. Instead it is the organizational response to macro-political changes -- large scale federal budget cuts -- that produced the result in question.

Tax policy. Tax policy is important to the discussion of cash cows for three reasons. First, the major portion of government policy on nonprofit organizations is accomplished through tax policy. There is some policy is that realized through administrative regulation of nonprofits receiving government grants and contracts and some is achieved through state laws establishing the requirements for incorporation of nonprofit organizations. Nonetheless, most policy, especially policy on commercial activity, is a matter of taxation.

Second, as the chief means of government oversight, tax policy regarding cash cows is the locus of political dialogue over the legitimacy of commercial activity. That dialogue as recorded in congressional testimony, court cases and ancillary documents is, unfortunately, the only significant source of historical information on the pursuit of commercial revenue by nonprofits. In this respect tax policy is important, not for itself, but as a vehicle for historical inquiry.

Third, tax policy limits and shapes the types of commerce that nonprofits can pursue and it effects the potential profitability of that commerce.

Broadly speaking, tax treatment of commercial activities has taken two forms: the destination test prior to 1950 and the relatedness test from 1950 onward. Not surprisingly, not until the income tax became an important part of the fiscal landscape with the establishment of the national permanent income tax in 1913 (Witte 1985) did tax treatment of nonprofits and of cash cows become a political issue. Major policy on the tax treatment of cash cows was first established in 1924 in a Supreme Court case, Trinidad v. Sagrada Orden de Predicadores (263 US 578). In a case concerning a Philippine[10] religious order which used rental income from substantial landholdings and sales revenue from articles sold to churches and related institutions, the Court found such income to be tax exempt because of the use to which it was put. According to the destination test, as this criterion was called, the taxability of income from commercial activities carried on by nonprofits was exempt as long as that income was used for charitable purposes. The destination rather than the source of the income was determinative.

It is important to understand that corporate income is now and was at the time of the Sagrada decision, taxed twice. First, the corporation pays taxes on its net income. Then, shareholders pay taxes on the dividends. According to the destination test, nonprofit organizations owning and operating businesses paid taxes at neither point. Regardless of the exemption test used, however, the second level of taxation is nonetheless generally avoided if the shareholder is a nonprofit organization.

By the early 1940s, both the Treasury and the Bureau of Internal Revenue (the predecessor to the IRS) were starting to object to the destination test and to consider the tax revenue and social policy implications of allowing charities to be extensively involved in business activities (Blodgett 1946, 420).

What brought cash cows to the attention of the public, however, was the Mueller Macaroni case. A group of wealthy New York University Law School alumni purchased the C.F. Mueller Company, the country's largest manufacturer of noodles, macaroni and pasta. The alumni, hoping to provide a source of income which would allow their alma mater to achieve greater prestige in the academic community, acquired the company using techniques that we would now call a leveraged buy-out. While the action differed little from the pre-war cases of nonprofit commercial activity, the reaction here was instantaneous and vociferous. Fortune Magazine ("Tax Abuse..." 1950) and The New Republic (Mezerik 1950) editorialized about the scandalous behavior of charities and one Congressman thundered that "if something is not done ... the macaroni monopoly will be in the hands of the universities" (House Ways and Means Committee 1950, 580).

But contrary to some accounts, it was not the Mueller case in and of itself that galvanized Congress and the public. The House Ways and Means Committee initiated hearings in 1947 on the conduct of businesses by tax exempt organizations. Congress was concerned about cash cows several years prior to the hubbub over Muellers. Even representatives of the nonprofit sector were curious about the extent of commercial activity within their domain.

One form of nonprofit commercial activity which most observers found especially vexing was sale-leaseback of real estate. According to Congressional testimony (House Ways and Means Committee 1950, 176; Senate Finance Committee 1950, 560-66), colleges and universities were involved in extensive sale-lease back operations with department stores. For example, in the first widely publicized case, Allied Stores sold the real estate associated with some of its operations to Union College. The college then leased the property back to the department store. In such transactions, the property was typically sold at above market costs which the nonprofit organization recouped because it paid no real estate taxes or income taxes on the transaction. The department store benefited both from an above market sales price, a below market rental rate and the deductibility of the rental payments.

This arrangement spread rapidly and by 1950 Yale had sale lease-back arrangements with Macy's in San Francisco and Frank & Seder in Philadelphia; Harvard with Gimbel's; Oberlin College with Montgomery-Wards, Sears, and Woolworth's; and the University of Pennsylvania with Lit Brother's in Philadelphia.

Public ire was generalized and unspecific. Many of the abuses cited were instances of businesses establishing charities or foundations in order to maintain control of corporations in the face of estate taxation or simply to avoid taxation. These cases were conflated with instances where operating nonprofits such as universities pursued commercial revenue.

The policy concerns of Congress centered on two issues: the potential that tax exemption gave nonprofits unfair competitive advantage over taxable businesses and the loss of tax revenues engendered by the removal of industrial and commercial activities from the tax base. I will discuss the economic validity of the claim that tax exemption generates unfair advantage in the section on unfair competition below. Regardless of the technical merits of the complaint over unfair competition, Congressmen treated the issue as self-evident and serious.

With regard to the impact of nonprofit cash cows on the tax base, the Treasury estimated that tax revenues of about $100 million were forgone through their tax exemption. Other analysts argued that the forgone revenues were closer to three or four million dollars (Note 1951, 852, 852n9; Senate Finance Committee 1950, 514).

The result of these revelations and of the concern shown by Congress was a fundamental change in tax treatment of nonprofit commercial activity. The Congress established a relatedness test to replace the destination test. Now the standard for taxability was the relatedness of the revenue-raising activity to the nonprofits' basic tax exempt mission. Commercial activities pursued by nonprofits deemed to be unrelated were subject to the unrelated business income tax (UBIT). If such activities were carried out under the auspices of a separate for-profit corporation -- a feeder corporation -- revenues from those activities were fully taxable at the corporate rate.

Few changes of significance to the issues treated in this paper have been made in the taxation of nonprofit commercial activities since 1950. While the tax treatment of foundations was drastically revised in 1969, only technical changes in the relatedness test were made. Some classes of nonprofit organizations, primarily churches, social welfare organizations and a variety of mutual benefit organizations, that had been previously excluded from the coverage of the unrelated business income tax were now covered by that tax. Also, the tax exemption of rental properties owned by nonprofits was further restricted in order to thwart new, more sophisticated versions of the sale-leaseback tax avoidance (Treusch and Sugarman 1983, 244-251). These amendments raised no political interest of the magnitude surrounding the 1950 policy changes. Not until the 1980s with the mobilization of the small business community over the unfair competition issue did this tax policy issue regain political salience.

The battles over taxation of commercial activities are of importance to theories of the nonprofit sector in three respects. First, the vagaries of the tax code provide opportunities for nonprofits to earn revenue and concomitantly, the increasingly stringent treatment of commercial activities limits those activities. Second, attempts by nonprofits to affect tax policy -- either to obtain favorable treatment or to mitigate punitive sanctions provides a link of a political sort between individual nonprofit organizations and the macro-political environment in which they operate.

Third, political conflict between nonprofits and other sorts of institutions and groups such as small business or ideologically motivated factions, imposes a constraint on individual nonprofit organizations' activities. In the models that characterized nonprofit organizations as institutions that engage in cross-subsidization, we saw that there were generally two classes of activities in which the organizations engaged: mission activities and subsidizing activities. From the perspective of those that operate the nonprofit organization, the identity of the latter activities is unimportant as long as they meet certain minimum criteria of profitability and lack of constraints or disutility. In contrast, the identity of the mission activity is important -- it is what motivates the very operation of the organization.

Politics may be integrated into these models by portraying the controversies as the means by which various groups in society either intentionally or unintentionally raise the costs of one of a set of potential subsidizing activities relative to other possible sources of subsidy (e.g., the cost of commercial activities versus the cost of donations). The costs can be raised directly as nonprofit managers find the controversy requires managerial attention or as public disaffection is manifested in decreased financial support. Or the costs may be imposed indirectly through the eventual policy that is implemented.

This is not just idle theoretical rumination. The political strategy of the small business critics of nonprofit organizations explicitly includes a component geared toward changing the public perception of nonprofit organizations in order to influence the profitability of certain sources of revenue (Pillsbury 1987, 39). The "halo effect" is just as much a target as the tax exemptions.

Policy Implications: Competition Between Nonprofit Organizations and Small Business

The controversy over competition between nonprofits and small business provides an opportunity to indicate some of the policy implications of this discussion of commercial activities and nonprofit theory. I want to suggest in this section that while small business substantially misunderstands the nonprofit sector and uses a notion of fairness that is not consonant with the economic theory of taxation, firms competing with nonprofit organizations may be bearing an undue burden of the cost of social and cultural services in the United States.

It is helpful to begin by stating some of the central aspects of the controversy up front. First, generally but not universally, it is small business that is upset about competition from nonprofit organizations. Only in health care, where large investor-owned for-profit chains are competing with large nonprofit chains, does one see big business involved. Second, the major complaint is that nonprofit organizations enjoy tax exemption not available to their business rivals that gives the nonprofits an unfair competitive advantage. Sometimes the complaint is that nonprofits should not be competing at all, regardless of tax exemption. Third, the privileges enjoyed by nonprofit include:

- exemption from federal, state and local income taxes;
- exemption from state and local property taxes;
- exemption from state and local sales taxes, both on sales to and from nonprofits;
- exemption from federal unemployment tax (FUTA);
- exemption from the provisions of the antitrust statutes;
- preferential postal rates;
- exemption from certain aspects of price discrimination, unfair competition, securities, copyright and bankruptcy regulations.

These privileges vary by state and locality as well as by type of nonprofit organizations (e.g., mutual nonprofits enjoy fewer privileges than 501(c)(3) organizations).

Most of the conflict revolves around related commercial activities of nonprofit organizations. Because such activities are related, usually they are tax-exempt. As such, they may be advantaged in the market and their advantage appears to many people to be illegitimate regardless of its material impact or other factors. Related activities also pose a competitive threat to small business competitors because there are often cost efficiencies associated with the conduct of the combination of the related and mission activities. In addition, the nonprofit organizations may have privileged access to clientele that small business competitors find difficult to counter. Universities and hospitals often have captive markets that businesses find inaccessible.

Unrelated business activities are usually less a matter of contention. These activities are taxable either through the unrelated business income tax or through corporate income taxes if conducted through a separate subsidiary. To the extent that they are less intimately bound up with the nonprofit's mission activities they resemble conventional competitors to their small business rivals.

Competition over fees-for-services tends to have a different character than competition of the other two types. For-profit and nonprofit firms can only exist in the same market if the consumers in that market have income with which to purchase the relevant services. The source of that income can be third-party payments, the consumers' own resources if the consumer is not economically disadvantaged or the government if the service in question is purchase of service contracting. Frequently, the nonprofit providers pre-date the for-profit providers in these markets.

Arguments of the Interests. The small business community finds competition from nonprofit organizations both illegitimate and unfair. The illegitimacy stems in their view from the fact that there should be no nonprofits in markets capable of sustaining for-profit commerce regardless of prior circumstances. The unfairness arises from the exemptions and benefits provided through government policy.

Small business advocates make two sorts of claims about the illegitimacy of the presence of nonprofit providers in the market. First, they lament the shift of nonprofit organizations from donative funding to fees-for-services and for-profit activities. Nonprofit organizations obtain their special status, in this view, because they are charities. Second, the purpose of nonprofits is to do what business is incapable or unwilling to do. Therefore, if business finds a market viable that it had previously declined to serve, it is appropriate and fair that nonprofit providers already present in the market face new competition or that the nonprofits relinquish their tax advantages or even that the nonprofits exit that market.

Unfairness is thought to occur because tax and related advantages allow nonprofits to underprice their competitors and to use retained earnings to expand faster or to avoid bankruptcy. In addition, the community good will that nonprofits enjoy is thought to produce a "halo" effect that induces consumers to favor them over their small business competitors. Some advocates insist that they welcome competition from nonprofit organizations but maintain that that competition should be played on a "level playing field," that is, that no competing group should advantaged. Other advocates argue that nonprofits should not be competing at all but since banishing them from the market is politically infeasible, revisions of government policy should reduce the advantages enjoyed by nonprofits. Generally, it is the related commercial activities of large nonprofit organizations in the health care and higher education sectors that is the object of most of the ire of the small business critics.

The remedies recommended by the small business community include tightening the criteria for exemption of commercial income under the relatedness test, improving federal data collection efforts so as to reveal the exact extent of nonprofit commercial activity and increasing the efficacy of enforcement mechanisms and associated penalties (SBA 1987b).

Representatives of the nonprofit sector dispute both the characterization and the extent of the problem. They reject description of nonprofit organizations as exclusively dedicated to service to the poor or as primarily funded by donations. They argue that the socio-economic status of their clientele is appropriately diverse (concentrating on the lower middle and middle classes). Provision of services exclusively to the poor, they assert, would stigmatize the recipients of the services.

Nonprofit advocates also argue that an objective examination of the unfairness of competition would take into account the advantages enjoyed by small businesses, including subchapter S tax treatment[11] and government contract set-asides.

Nonprofit organizations also dispute the notion that nonprofits do not belong in markets where businesses are capable of providing services. Arguing that business firms' provision of services can be erratic because their participation in a market is tied to the vagaries of that market, nonprofits counsel that their long term interest in providing predictable and uninterrupted service to the public be recognized and their need for institutional stability be acknowledged.

Nonprofit advocates claim that existing data do not clearly indicate one way or another whether nonprofits are extensively involved in commercial activity. They say that it is premature to pursue reforms of the tax code in the absence of more definitive data. They particularly disagree with the conflation of for-profit activities with fees-for-services. The combination of data from those two categories inflates the magnitude of the activities considered to be unconventional.

Economic Analysis of Unfair Competition. Economic analyses of the unfairness of competition tend to be rather complicated compared to allegations that nonprofit competition is unfair *prima facie*. According to an analysis by Rose-Ackerman (1986a), fairness is importantly a matter of foreknowledge and market structure. From an economic point of view no group of firms is entitled to above market returns nor should such a group be forced to endure below market returns for noneconomic reasons that cannot be anticipated prior to investment. If an investor enters a market that he or she knows is characterized by below market rates of return, then there is no unfairness. (There may be inefficiency, but that is a different question.)

There are several concepts from the economic study of taxation that are important to understanding Rose-Ackerman's argument. First, horizontal equity is the basic criterion employed in discussing the fairness of taxation. This principle mandates that entities in similar situations should pay the same taxes.

Second, the incidence of taxes must be distinguished from their burden. The former refers to who is formally responsible for the payment of taxes; the latter to who actual bears the economic burden of the costs of the taxes. If a firm, for example, can pass the costs of taxation through to its customers then the customers sustain the burden while the firm only bears the incidence.

Third, one class of investors may be advantaged through the exemptions that their firms enjoy but if public policy indicates that those advantages are warranted to achieve some social objective then fairness becomes a matter of the legitimacy of the means and substance of collective decisionmaking. If a legislature decides that charities should retain more of their earnings than business stockholders, this may be deemed fair if the means by which this choice is made is deemed fair. This is not a question appropriately analyzed with economic theory.

Rose-Ackerman argues that the two key advantages thought to arise from tax exemption -- opportunity to engage in predatory pricing; and the ability to grow faster and thereby avoid the risk of bankruptcy due to faster accumulation of earnings -- are neither true nor false prima facie. Instead, empirical conditions shaped by market structure, tax laws and the capital market determine whether nonprofit tax exemption forces for-profit competitors to endure below-market returns.

Predatory pricing due to tax exemption is not a valid concern. If lower prices were profitable, for-profits would lower their prices as well. But nonprofits may influence market price without engaging in predatory pricing by entering a market where marginal for-profits are just breaking even. The entry of the nonprofits shifts the market supply curve outward (i.e., it expands the amount of goods and services supplied by the industry as a whole) and thereby lowers prices. If exit is costly for for-profits, they may face lowered prices even if no competitor sets prices below cost.

Similarly, whether or not a for-profit firm is disadvantaged vis-a-vis bankruptcy risks depends on the tax treatment of losses and the availability of capital. Bankruptcy risk is relative risk. This is easiest to see in a situation where demand is unexpectedly low. All firms face risk, but a firm's risk is lower if there are competing firms more marginal than it, because the exit of marginal firms with the smallest reserve of past earnings will increase prices and improve market conditions for the surviving firms (1986a, 42).

Nonprofit organizations can retain more earnings than for-profits, ceteris paribus, because those earnings are not taxed. This increases for-profits' relative vulnerability to bankruptcy. However, that is only true if loss carryover provisions of the tax code are neglected. The greater the carryovers, the smaller the differences there are between nonprofits and for-profits in the ability to accumulate retained earnings and therefore the less difference there is in bankruptcy risk.

Rose-Ackerman draws from her analysis a strikingly counterintuitive finding: unfairness to for-profit firms will be lessened if the unrelated business income tax (UBIT) is repealed. She argues that a tax that would remove unfair advantage is theoretically possible but administratively intractable because it would have to be sensitive to factors such as whether the for-profit firms were enjoying above market returns, whether there was excessive nonprofit entry and whether exit would be costly for for-profit firms. She suggests that absent such a complex tax, the UBIT increases injury to for-profit competitors by concentrating nonprofit business activities in specific lines of business -- those exempt from the UBIT and corporate income tax -- and increasing the likelihood that returns to investment in such a market will be lowered. She suggests that repeal of the UBIT would disperse nonprofit commercial activities across the economy, mitigating the magnitude of the impact of nonprofit competition on individual industries.

Policy Implications. There are both positive and normative implications to be drawn from my analysis of cash cows for the current controversy. To the extent that cross-subsidization is a key feature of nonprofit organizations and that in some way or another nonprofits pursue activities unsupportable in the market, several important inferences can be drawn. First, those nonprofits that support themselves solely through fees-for-services may not be entitled to tax exemption and related public subsidies and dispensations. Their ability to operate solely on the basis of fees-for-services implies that their services lack a redistributive or collective component. This criterion would not disallow exemption for nonprofit organizations that operate partially on the basis of this sort of financing or that employ sliding scale fee systems.

Second, the small business community's attempt to limit nonprofits to donative financing and narrowly charitable activity misconstrues what nonprofits are about currently and historically. If the historical research that is beginning to emerge is correct, pure charities are more a part of American folklore than of the actual American political economy (Hall 1987b).

The discussion of the role of politics and policy in shaping nonprofit commercial activity raises concerns in a different dimension. Advocates of various ideological stripes look to nonprofits to play a vital role in the welfare state. Some conservative privatizers want them to relieve the load on government. Even those not advocating privatization see a crucial role for nonprofits in service delivery, advocacy or constituent participation. As various forms of financial support available to nonprofits are successively curtailed -- government funding, charitable deductions, and now commercial cross-subsidization -- policymakers need to face up to the possibility of the gradual enfeeblement of the nonprofit sector.

This raises an important point about the dispute over fairness. While the dearth of data and the complexity of the requisite analysis makes conclusions hard to come by, it is probably the case that fairness is not a matter of leveling a tilted playing field because the field is not tilted but bumpy. That is, the unfairness may not lie so much in the relative advantages that nonprofits have over their small business competitors -- the magnitude of the nonprofit advantage has yet to clearly established especially in an analysis that incorporates small business tax advantages. Instead, the unfairness may lie in the fact that small businesses are bearing the burden, through depressed market returns, for a portion of the cost of public services that might be more equitably distributed through the general tax system. If nonprofits received more funding through government, or if services provided by nonprofits were provided directly by government, then the cost of those services would be spread through out the tax base rather than being imposed on small business through nonprofit competition. In this sense, small business is bearing an undue portion of the cost of the welfare state.

The policy implications of this perspective on unfairness are complex. First, this perspective relies on the sort of market analysis described by Rose-Ackerman where subcompetitive returns on investment for an industry have to be established. Second, remedies for the inequities that are found could include (i) more direct government funding for nonprofit organizations in order to decrease their incentives to pursue commercial revenue, (ii) a shift to direct government provision of public services, (iii) increases in tax deductions for charitable contributions in order to increase donative funding, (iv) compensation for small businesses hurt by nonprofit competition and (v) an explicit choice to reduce the relevant public services by prohibiting certain sorts of nonprofit commercial activity without providing compensating increases in funding for nonprofits or without increasing government provision.

Some of these remedies have obvious drawbacks. The shift to direct government provision undermines whatever virtues nonprofit provision provides by reducing this sector's role. Compensation for small business is administratively complex and suffers from difficulties of establishing clear and legitimate standards of injury. The proposals for greater government funding or increased tax incentives for giving produce fewer negative consequences but it has been precisely the movement of public policy away from such subsidies that has contributed to the pursuit of commercial revenue by nonprofits. Concern over the federal budget deficit militates against the re-adoption of these approaches. In the short term, it appears that, if small business succeeds in its political quest, the "remedy" employed will be limitations on commercial activity and reduced nonprofit services. We will have both fewer sacred cows and fewer cash cows.

I began this paper by pointing out that commercial activities of nonprofit organizations violate our commonplace conceptions of what nonprofits are about. The apparent anomaly of organizations whose distinctiveness rests in their being unlike businesses, acting like businesses, motivates the two stage process of this inquiry. First, I have asked what exactly we mean by nonprofit organizations and then I have asked how well those answers have accommodated commercial activity.

In order for commercial activity to be an anomaly, there must be a coherent notion of "nonprofitness" against which to measure the aptness of this particular activity. Throughout this paper I have argued that cross-subsidization is an important, perhaps essential feature of both nonprofits in general and of their commercial activities in particular. Cross-subsidization is not unique to nonprofit organizations -- large business firms subsidize one line of business with the profits of another in expectation of future returns from the first, deficit-producing line. However, if economic theory is correct, the capital market constrains the firm's ability to indefinitely postpone the payoff from that money-losing activity. In contrast, the nondistribution constraint isolates nonprofit organizations from the capital market, thereby relieving it of the pressure from investors and allowing it to take on as its raison d'etre, activities which cannot support themselves.

Cross-subsidization provides a plausible behavioral account of much nonprofit activity. It is a "supply-side" theory in the terminology introduced earlier. It is less powerful in accounting for demand factors or in explaining the role of nonprofit organizations in society. I cannot provide, at this point, a comprehensive theory of the role of nonprofit organizations based on my analysis of them as cross-subsidizers. I can, however, argue that the behavior in question is more easily understood when the nonprofit sector is viewed against the backdrop of its environment. Some of the models I have reviewed (e.g., James and Rose-Ackerman) have incorporated the impact of the government and business sectors on nonprofit organizations but they generally leave out or under-emphasize the importance of the macro-political environment.

Thus, the analysis of cash cows and the broader study of nonprofit organizations of which that analysis is a part is largely an inquiry into whether or not there is something usefully labeled as "nonprofitness." This inquiry is part of a larger theoretical endeavor which aims to discover what the differences are between public and private institutions or activities -- if there is "publicness" or "privateness."

One of my theoretical aims in this paper has been to cast doubt as to whether nonprofit organizations (or by implication, government) are a residual category of social organization. Instead, I have tried to argue that logically and historically the market are not prior -- that "nonprofitness" or "publicness" is not simply what "privateness" cannot accomplish. By making the argument that macro-political factors influence intersectoral and intrasectoral behavior, I am making claims about what kind of factors are important in the analysis of the political economy -- I am arguing for the necessity of bringing the state back in. To go even further, by arguing for the importance of macro-political factors I am suggesting that politics and government may be prior or at least of comparable importance in shaping the relationships between the various sectors.

NOTES

1. Cash cows represent those lines of business which are central sources of cash for a conventional business firm. Because of their extremely strong competitive position in a declining market, cash cows generate more cash than they can prudently reinvest in themselves. They therefore represent a large source of cash that can be used for development of other businesses within the firm. Businesses "milk" cash cows for their cash (Hax and Majluf 1983).

When used in the world of nonprofits, the term has a more inexact usage (and wistful connotation): cash cows are businesses that yield funds that can subsidize money-losing activities that a nonprofit organization wishes to maintain or pursue.

2. By charities I mean nonprofit organizations that are (i) donatively financed, (ii) provide free or below market cost services and (iii) serve the disadvantaged.

3. This is the nomenclature that the IRS uses.

4. I describe two models developed by James in this paper. The first one, outlined in this section deals with the behavior of nonprofit organizations. The second, described in the following section focuses more on the role of nonprofits and their relationship to government and the market. There is some evolution in James's thinking which I discuss in the context of her second model.

5. In addition to the problem of how economic models treat redistribution, there are several other limitations of this form of analysis germane to the study of nonprofits including the fact that theories that account for the existence of nonprofits on the basis of market failure confound history; economic theories of institutional change frequently misuse notions of natural selection; and economic theories of cross-subsidization lack well developed accounts of second best solutions.

6. Salamon (1986, 5) notes less than one-third of the nonprofit agencies surveyed in the Urban Institute's study of the nonprofit sector indicated that they focused on serving a low income or poor clientele.

7. According to Skocpol (Evans, Rueschemeyer and Skocpol 1985, 21), Alexis de Tocqueville applied this approach in his works, The Old Regime and The French Revolution and Democracy in America.

8. Public goods are nonrival -- their consumption does not use them up -- and nonexclusive -- if they are provided to one consumer it is impossible to exclude others from consumption.

9. That is, lack of donative support in terms of proportionate shares of nonprofit revenue. For more detail on this see the section on privatization below.

10. The Philippines were an American colony at the time.

11. Subchapter S of the Internal Revenue Code allows corporations to exempt themselves from the corporate income tax if they meet certain criteria. Election of this status allows the corporations to avoid double taxation by distributing profits to shareholders without facing corporate level taxation. The profits are treated as personal income and taxed at the appropriate and generally lower individual rate (Wellford and Gallagher 1985, 11).

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Opening Remarks of the
Honorable Silvio O. Conte
Hearing on Non-Profit Competition
June 29, 1988

Mr. Chairman, thank you for convening two hearings on the issue of non profit competition. I believe that these hearings and the hearings conducted in Ways and Means by my good friend J.J. Pickle will greatly contribute to the dialogue and ultimately our further understanding of this most sensitive and complex issue.

All of us here support small business. Many of us donate our time and money to non profits. Support for both is not mutually exclusive. Both small business and non profits are an integral part - a very important part of our economy and society. Both should flourish.

At issue is whether non profits abuse their tax exempt status. Under current law, business income not substantially related to the principal purpose of the non profit is taxed at corporate rate. The problem is how do you define the distinction. What is substantially related?

Before we begin to define the distinction, we need to consider the legitimate needs of small business and the needs of our non profits. For instance, what is the impact of declining rates of charitable donations on non-profits? What impact do non profits have on creating business for others? What is the impact of the 1986 tax changes on non-profits? What is the impact of new taxes on budgets of non-profits? Finally, what is the impact of declining public funds on non-profit stability?

The small business community, looking at a $100 billion per year growth industry is understandably concerned that this growth has come at the expense of America's small businesses. Their basic position is that a tax-exempt organization is essential when it performs an unmet societal need; In other words, when it provides a public good. But when the same service is available in the for-profit sector, the "public goods" argument no longer applies. Therefore when similar commercial activities are conducted by a nonprofit and a for-profit organization, the non profit organization should not be entitled to a tax break. In their opinion, this is simply providing the nonprofit with an unfair competitive edge.

One of the major problems in addressing this issue or non-issue, whatever the case may be, is a lack of hard empirical data. What we have is clearly not enough and may not be accurate. Unquestionably, the first step in determining if there is a problem is to establish meaningful data. Until we do, let us not react to perceptions. Let us examine hard data and then make a determination.

I look forward to the testimony of our distinguished panelists today and commend the chair for his leadership in convening these hearings. Thank you.

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COMMITTEE ON EDUCATION AND LABOR
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SUBCOMMITTEE ON POSTSECONDARY EDUCATION

COMMITTEE ON SMALL BUSINESS
TESTIMONY OF REP. PATRICK WILLIAMS
WEDNESDAY, JUNE 29, 1988

Mr. Chairman, Members of the Committee, thank you for permitting me to testify today as you begin your consideration of the important issue of competition between nonprofit and small business organizations. I commend you, Mr. Chairman, for your willingness to conduct a fair and careful review of this difficult issue.

I have been a member of the Committee on Education and Labor since I came to Congress, and I now serve as the Chairman of its Subcommittee on Postsecondary Education. Through my association with higher education issues, I am acutely aware that there is a tension developing, or already existing, between some small business representatives and the higher education community. This tension is based on the belief that colleges and universities, by virtue of their tax-exempt status, are competing unfairly with small businesses in some areas. This tension is unhealthy, and it represents an issue that needs to be addressed.

Today I want to talk about the special role I believe higher education plays in our nation, and about some dire funding realities that are facing our colleges and universities. First, I want to emphasize that I do not support unfair competition between the higher education community and small business. I believe that where colleges and universities engage in commercial activities that are unrelated to their basic mission as an educational institution, they should pay taxes. And they do. Colleges and universities are subject to a corporate tax on business activities that are unrelated to their exempt educational and research functions. In fact, colleges and universities presently pay this tax on income generated by such unrelated activities as hotel accomodations, computer equipment, or athletic facilities used by the general public. Many colleges and universities do not engage in such income-generating activities, but do provide important support services for students at the lowest possible cost. And in many cases, it is the provision of these essential support services that are the subject of small business complaints.

I do not think that I need to emphasize the unique mission colleges and universities play in the vitality of our economy and the lives of our fellow citizens. They are essential to our development as a nation. They train our citizens; they explore new areas of knowledge and learning; they pave the way for our healthy existence in the future; and they develop the skills and culture that make us the envy of the world. No other entities perform these functions any more effectively. And none could.

Yet all of this costs money, and colleges and universities have to continually search for creative ways to finance their activities. They continue to rely on their traditional sources of revenue, sources such as tuition, state support and gifts. They have not shifted their revenue base to a reliance on unrelated business activities. Admittedly they are trying to develop new ways to raise revenues. Yet I have seen no evidence that traditional patterns of nonprofit support have been abandoned. Those traditional patterns continue to be the way most colleges and universities raise their money.

Mr. Chairman, it is important to note that Congress has a proud history of supporting the goal of making college available to all who had the desire and the ability to pursue it, but who were prevented from pursuing it simply because of lack of finances. An important component of this goal is our commitment to keeping the costs of higher education and the amount paid by students as low as possible. To do otherwise is to risk denying access to bright and capable people whose education benefits us all. This past fall my Postsecondary Education Subcommittee conducted hearings on the all-too-familiar theme of rising college costs. Some of the reasons for increasing costs are similar to those burdening small businesses: rising labor expenses, the need to comply with new and complex federal regulations, the price of oil and building materials, and mandated benefits. In addition, colleges and universities must purchase unique and costly materials and equipment that are essential to education, such as state-of-the-art science equipment, research laboratories, teaching materials, and limited-edition library books. This pushes the costs even higher.

Furthermore, there were changes contained in the Tax Reform Act of 1986 that in some cases have added directly to the costs of education. Changes in laws affecting charitable giving make it harder to raise money. And the taxation of significant parts of scholarships--at a time when our federal support is not keeping up with educational costs--requires colleges and universities to raise more money to provide additional scholarship funds to students who are finding that they are receiving less federal aid. The Tax Reform Act also limited the availability of tax exempt financing for facilities, and even denied it to some of our nation's larger research institutions, thereby increasing the cost of building or rebuilding to respond to changes in the educational curriculum.

And we have not been able to increase our support to students and to their families to meet these rising costs. In 1985, we eliminated the Social Security benefits payable to students, reducing an important source of funds used by needy students. The Higher Education Amendments of 1986 reduced the authorization for higher education purposes by over $1 billion. And despite increases in student aid appropriations, the purchasing value of these funds has actually decreased over the past ten years. Nor is this situation likely to improve soon.

In the face of rising costs, colleges and universities have tried to keep students' expenses as affordable as possible, by making available necessary housing, books, food, and support services in the most inexpensive manner. Some run campus bus services, pass through computer manufacturers' discounts to students, operate bookstores and campus health facilities, and provide on-campus childcare. These are not activities designed to make money; rather they represent thoughtful and constructive attempts to keep education accessible and affordable for struggling students. And many of these attempts were initiated exclusively by colleges and universities. They did not exist previously.

I know that you will hear a witness representing higher education on your next panel who undoubtedly will be more specific about the particular concerns raised by the small business community, and about the areas in which higher education can be helpful in alleviating any specific identifiable problems. For it is in all of our best interests to eliminate these problems and remove any unhealthy tensions that are developing between the small business community and higher education. No one benefits from such an environment.

I am grateful to have this opportunity to talk about the special role higher education plays in our nation, and to urge this committee to consider that affordable higher education is an important goal to pursue, and that such a goal should be weighed carefully as you undertake your review of the important issue before you. Thank you.

Business Coalition For
FAIR COMPETITION

TESTIMONY OF

JOSEPH F. O'NEIL

CHAIRMAN

BUSINESS COALITION FOR FAIR COMPETITION

BEFORE THE

COMMITTEE ON SMALL BUSINESS

U.S. HOUSE OF REPRESENTATIVES

JUNE 29, 1988

1725 K Street, N.W. • Suite 412 • Washington, D.C. 20006
(202) 887-5872

My name is Joseph O'Neil and I am here today on behalf of the Business Coalition for Fair Competition (BCFC). The BCFC is an alliance of trade and professional associations and businesses that share a common concern over the phenomenon know as "unfair competition." The coalition, which was formed in 1983, represents a significant portion of the small business community and a wide range of economic activity. A list of BCFC participants is appended to this statement.

The problem of unfair competition by nonprofits has rapidly become a top concern of small business. In 1980, the Congress and President Carter sponsored a White House Conference on Small Business. Nearly 2,000 small business owners, elected by their colleagues in local meetings, attended the conference. The delegates reviewed hundreds of proposals and selected 60, 15 of which were identified as immediate priorities. Unfair competition by nonprofits was the subject of three of the 60 proposals, but none was included in the top 15. In 1986, a second White House conference on Small Business was held. This time, one session focused almost entirely on the issue of unfair competition, and the third highest recommendation of the Conference called upon government to eliminate unfair competition by nonprofit with small business. In 1987 the House Ways and Means Subcommittee on Oversight held five days of hearings on nonprofit commercial activity and the unrelated business income tax (UBIT) regulations. In March of 1988, the Business Coalition for Fair Competition sponsored the first Annual Conference on Unfair Competition in Washington, DC. More than 150 attendees from a variety of industries who share the frustration of unfair competition met with each other and with their members of Congress to further the educational program of the Coalition.

Recently, the Oversight Subcommittee released a set of discussion options for UBIT reform and held an additional hearing on the subject. These actions created even greater public awareness of the UBIT problem. The fact that the issue has generated such concern suggests that the problem is reaching crisis proportion.

The first step in an analysis of the problem is to define what is meant by "nonprofit." The term encompasses a wide variety of entities and is commonly associated with the Federal tax exemption. (Hereinafter references to tax-exempt or tax exemption refer to the exemption from Federal income tax). For the purposes of unfair competition, tax-exempt and nonprofit are virtually interchangeable terms. However, in theory, the term nonprofit describes a broad classification, of which tax-exempt organizations are but one subgroup. The common denominator of nonprofits is that their charter or articles of incorporation prohibits them from distributing their earnings to any individual or entity that exercises control over the organization. Historically, state laws limited nonprofits to certain purposes. Over time, states have removed this requirement; and, generally, nonprofits may be formed for any lawful purpose. Even the term "nonprofit" is a misnomer. Distribution of the excess of income over expenses is not, in itself, profit. Profit, in its purest sense, is the excess of revenue over expenses; many nonprofits enjoy such excess. Further, preservation and compensation of management or the expansion of capacity can drive the profit motive as well as can return on investment. To make a distinction merely on the distribution of earnings diverts attention from the larger issues.

As a practical matter, most significant nonprofits seek an exemption from Federal income tax. The Exempt Organization Master File of the Internal Revenue Service listed over 925,000 entities at the end of 1987. These include voluntary and philanthropic organizations such as schools; hospitals; social services; advocacy organizations; civic, social and fraternal organizations; arts and cultural organizations and foundations; religious institutions; and business leagues.

Subchapter F of the Internal Revenue Code (hereinafter Code) includes 25 specific categories of exempt organizations. Nearly half of all tax exemptions are granted to organizations under the criteria of code section 501(c)(3) for religious, charitable, scientific or educational purposes. It is these organizations that generate most of the competition with for-profits. Section 501(c)(3) organizations are generally service-oriented, that is, they generate revenue by providing services for a fee, and thus are more likely to compete for business. More than 50% of the total tax-exempt revenue is attributed to hospitals and educational organizations. These two areas represent the prime offenders in the competition battle.

Estimates of the size of the nonprofit, tax-exempt sector range up to $300 billion in annual income and nearly 9% of the Gross National Product. Even the most conservative estimates place it at 3% of GNP. In 1946, the nonprofit share of GNP was 1%. The growth of the nonprofit sector has been nothing short of phenomenal. Additional facts and figures not only place the size of the nonprofit sector in perspective, but also begin to demonstrate why the problem of nonprofit competition has emerged as a critical issue at this time. This information is derived from surveys of the principal organization representing nonprofits, the Independent Sector.

> Overall, the independent sector grew faster than other sectors in the national economy between 1977 and 1982. After 1982, this trend reversed. From 1977 to 1982, the independent sector increased its share of national income from 5.2 percent ($84.4 billion) to 5.8 percent ($155.8 billion). From 1982 to 1984, its share of national income declined to 5.6 percent ($176.3 billion). These figures include the value of volunteer time, which increased from $32.7 billion in 1977 to $74.4 billion in 1984 (2.4 percent

of national income).

From 1977 to 1982, the independent sector increased its share of total earnings from work from 6.7 percent ($75.9 billion) to 7.5 percent ($139.2 billion). From 1982 to 1984, its share of total earnings from work declined to 7.2 percent ($157.1 billion). These figures include the value of volunteer time, which increased its share of total earnings from work from 2.6 percent (29.2 billion) to 3.2 percent ($58.5 billion) between 1977 and 1982. From 1982 to 1984, this share declined slightly to 3.1 percent ($66.5 billion).

From 1977 to 1982, the independent sector increased its share of total employment from 8.6 percent (8.8 million) to 9.7 percent (11.0 million). From 1982 to 1984, its share of total employment declined to 9.5 percent (11.4 million). These figures include volunteer time, which accounted for the equivalent employment of 3.3 million employees in 1977 and 4.7 million employees in 1984. Had estimated volunteer employment not increased nearly 5 percent between 1982 and 1984, the decline in the rate of growth in employment in the independent sector in relation to the rest of the economy would have been more severe.

Employment in the independent sector increased at an annual rate of 3.7 percent from 1972 to 1982, which was much faster than the annual rate of growth for all nonagricultural employees (2.0 percent) during this period. From 1982 to 1984, the annual rate of growth for all nonagricultural employees was 2.7 percent, compared with 1.0 percent in the independent sector.

These figures demonstrate the growth of the independent sector but they do not explain why the sector has grown or identity which tax-exempts are the major sources of unfair competition.

The one feature that identifies potential competitors is the source of revenues. Those that derive income primarily from contributions are, by definition, not competitors; those that provide goods or service for a fee have the potential for being competitors. These two types of entities are frequently described as "donative" nonprofits and "commercial" nonprofits.

Unfair competition itself is easy to define, yet difficult to quantify. The unfair advantage is derived from the granting of special status by an external source, almost always the government, which either permits the entity to avoid governmental "burdens" (e.g. taxes) or to obtain direct support (e.g., grants). The exemption from Federal taxation is the most significant of these advantages. Others include exemptions from state and local taxes, lower subsidized postal rates, and antitrust exemptions, to name a few. Congress only recently granted another privilege to nonprofits, the ability to obtain contracts from the government on a sole source basis.

.Tax exemption is the most recognized unfair advantage, but it is difficult to measure the extent of that advantage. The Internal Revenue Code includes a provision that requires the nonprofit to pay an unrelated business income tax on activities deemed to be unrelated. Although the income of nonprofits surpassed $300 billion, they reported only $100+ million as unrelated income. Congressional review of UBIT and subsequent tightening of enforcement procedures is urgently needed and long overdue, but it is only a first step. For everyone engaged in commercial activity to receive equal treatment under the law, other types of preferential treatment now given commercial nonprofits must also be eliminated or substantially modified.

A significant "benefit" of nonprofit status is the aura of the government imprimatur. While the "aura" has been described as a rationale for the existence of nonprofits, it has, in fact, emerged as a major business advantage. The public has a perception that nonprofit managers of hospitals, nursing homes and other public-benefit organizations are guided by the service ethic rather than the commercial ethic and that they thus have a greater incentive to provide quality service at a reasonable price. The "contract failure" theory suggests that nonprofits assure the public of quality and performance in services for which the consumer is not able to make such judgments. The evidence now suggests that, increasingly, the aura serves as a marketing tool as much as a method of quality control and protection.

Another major area of disadvantage for small businesses that must compete with tax-exempts are state and local taxes and real estate taxes. The tax exemption allows nonprofits to outbid for-profits for land, location and facilities. Along those lines, the recent growth of commercial-type incomes among nonprofits and their ability to repay loans from tax-free income often makes nonprofits preferred borrowers!

Reduced postal rates are another advantage. At the request of Congress, in 1986 the Postal Rate Commission held hearings in Washington and seven other cities to examine the postal privileges of nonprofits. The result of these meetings was a report with specific recommendations from the Postal Rate Commission to shift these preferred rates from a taxpayer subsidy to a cost subsidy. A key recommendation would require nonprofits to pay the normal business rate for all their commercially-oriented mail. After the Postal Rate Commission's careful study of the problem, Congress has acted on only one minor accounting change called for in the report. This would certainly be an area where Congressional action could make a difference. The groundwork has been laid; the recommendations have been presented; now it is time for legislative action.

How do these exemptions or privileges provide advantage within the marketplace? The obvious answer is that the exemptions allow the nonprofit to lower the price of goods or services. A less obvious advantage is the ability to sustain the costs of market entry. The chance to devote more resources to advertising, to produce a better product and to underwrite the product is a tremendous advantage. The National Geographic, for example, through nonprofit donations is able to commit vast sums to the production of its magazine, which in turn creates new donors.

The damage of unfair competition is difficult to assess because the problem is national in scope but local in impact. This explains, in part, why the phenomenon hits the small business sector particularly hard. The competition takes place on an institution-by-institution basis. A small business competes against one university or one hospital. The central activity is the provision of service. Service, except to a limited number of franchise operations, does not lend itself to a national marketing strategy. A key index, if one were able to compile the data, is "opportunity lost." How many sales were not made by the for-profit, how many jobs were not created as the result of the sales not made or the taxes not paid on those sales? In a growing market, if a firm's sales increase 50%, but a nonprofit has siphoned off another 50% of the potential growth, how is one to know?

What is clear is that nonprofits have become increasingly reliant on income-producing activities. Contributions as a percentage of income have decreased from 17 to 13 percent, and dues have decreased from 26 to 12 percent between 1946 and 1978. Other income has increased from 57 to 75 percent. The nonprofit sector has gained market share, and it is easier to document their gain rather than the small businesses' loss. The correlation is clear, and not surprisingly, the concern of the for-profit business community regarding unfair competition has risen in direct proportion to the increase in the sale of goods and services by nonprofits.

Now that I have presented the framework of this problem, let me show you how it works through examples of my members' business dealings. To demonstrate the breadth and depth of this problem I will list examples from a variety of industries.

- Mr. Gerald Brong, co-owner of Community Computer Centers of Pullman, Washington (a university town), tells of how his computer dealership was forced into Chapter 11 bankruptcy in 1987. His business, in operation since 1982, encountered direct competition from a tax-exempt university, Washington State University. The local market for the sale of microcomputers, printers, data storage devices and software has become dominated by the University's own Personal Computer Center. This University retailer is tax-exempt, and benefits from tremendous name recognition and the other marketing advantages discussed earlier. The University Computer Center is also given preferential wholesale prices by manufacturers and publishers because of its status as a tax-exempt educational institution. This tax-assisted State University sells an estimated $2,000,000-worth of computer products a year.

- A Texas travel agency owner, Ms. Earlene Causey, reports that the University of Michigan sent approximately 2,500 people on alumni tours in 1986. It is estimated that major universities like USC and Illinois also sold tours to an equivalent number. The cost for these trips alone would total over $12.5 million. The 10% travel agent commission would have totalled $1.25 million. In addition, publications advertising such trips are mailed with nonprofit postage rates. Clearly, it was not the intent of Congress that Alumni Associations be given tax-exempt status and preferred postal rates so they could operate travel agencies.

- Within the testing field, there are major examples of abuse of tax-exempt status. One such example is Underwriters Laboratories, Inc. ("UL") which qualifies for tax-exemption under the "testing for the public safety" provision of Section 501(c)(3) of the IRS Code. UL operated as a profitable business until the "testing for public safety" language was added to the code in 1954. Today UL is a sophisticated, aggressive, rapidly growing $200-million-a-year business that differs from its for-profit competitors only in that it pays no taxes and enjoys the other benefits of nonprofit status. Beyond that, it is -- among other things -- a dominant monopoly in the electrical safety certification market. UL uses its monopoly position and tax-exempt status to move aggressively into other markets both domestic and foreign. It represents a serious threat to the development of and in some cases even the continued existence of a number of small testing firms.

UL is a perfect example of a big business enjoying "brand name" recognition. With its best known activities being in testing and certification of electrical and mechanical products, it has a mythical halo of doing good for the public. It is almost quasi-public in that many products in large measure cannot be sold or installed across the country unless the UL label or listing is present. Governmental code and inspection bodies by and large require such UL labeling and listing. These requirements give UL a status in the electrical safety certification market that is almost exclusionary to other, tax-paying testing businesses equally qualified to perform these services and who offer manufacturers a much-needed alternative to UL.

- The following story comes from a tour company located in Collinsville, Mississippi:

> As owner of...a fully licensed and insured motorcoach tour operation, I find myself in unfair competition with many churches and club groups in this area who are operating a tax-free tour business....Churches and organized groups began to offer...trips...as a special service to their senior citizens....This service met with such popularity...that it is now out of hand and the number of trips has multiplied like rabbits. Churches have purchased buses and are now offering extended trips, not only to their membership, but to anyone and everyone they can get to complete their bus load.
>
> I attend and support my church and several organizations, but I strongly feel that such groups should not be allowed to take such unfair advantage....Since I pay an enormous tax bill each quarter, I resent helping to subsidize this unfair practice that is hurting my own business. I am ready to register a complaint to someone, somewhere.

- According to the International Racquet Sports Association, the increased emphasis in our society on health and fitness is responsible for the proliferation of both tax-paying and tax-exempt health clubs. The YMCA has responded to this trend by building an increasing number of modern fitness centers. In some communities -- Portland, Oregon; Rock Island, Illinois; and Pittsburgh, Pennsylvania -- property tax assessors have determined that YMCA fitness facilities in their jurisdictions are no longer legitimate public charities and have revoked their property tax exemptions.

- Robin and John Holm, owners of the Washington Hearing Aid Center located in Seattle, Washington, relate the story of their competitor, a tax-exempt clinic, the Northwest Speech and Hearing Center. This clinic is affiliated with a tax-exempt hospital in Seattle. Prior to 1976, the Holms competed _fairly_ with 15 other tax-paying companies. Northwest Speech and Hearing Center opened in 1976 and had grossed $1 million and showed profits of $161,000 just three years later. The Holm's profits that same year were down $19,000 and from 1982 to 1986 net sales plunged approximately $100,000. Lower pricing is the major factor in the marketing techniques of this clinic. They capitalize on the halo effect and boast of offering lower prices because of their nonprofit status.

- Private clinical veterinary practices face unfair competition from tax-exempt organizations that offer the full range of veterinary services for a fee to the general public. An organization may exploit its tax-exempt status when it constructs its facility. For example, the 6,000-sq.-ft. Michigan Humane Society hospital was built at a cost of $1 million for construction alone, not counting site, equipment and furnishings. The cost per square foot for this facility was $167, more than three times the national average for veterinary hospitals. No private veterinarian could afford to build such an extravagant facility and hope to make a living with it. Additionally, the Michigan hospital does not confine itself to providing only charitable services. According to information provided by the Michigan Humane Society, the structure is a "full-service hospital which also functions as a low-cost sterilization clinic and a charitable hospital." The Michigan Humane Society also placed a three-color advertisement in the Yellow Pages proclaiming the hospital's "full-service" status. According to one of the veterinarians employed by the hospital, the facility sees approximately 30 to 60 clients each day and performs only about 10 spays and neuters. Nearly all this work could be handled by private practitioners in the same area.

Why do nonprofits compete? There are two types of competitors. In a number of fields, such as health care, the nonprofit has been the dominant provider of the service and it is for-profit firms that have sought a foothold in the market. More commonly, the nonprofits have expanded, entering thriving for-profit markets. The reasons for this latter expansion are clear. Escalating expenses, declining revenue and a rising demand for highly technical services have forced many exempt organizations into the commercial arena. More accurately, it is escalating expenses, declining revenues and *excess* capacity that have forced the exempts to look to the commercial arena. Nonprofits are professionally operated, and sophisticated management will adapt to maximize resources. At the same time, self-interest dictates that managers and employees will seek to protect their operation and expand their empire.

Several arguments for expansion by nonprofits into the for-profit markets have been: recent reductions in Federal support, "Reaganomics," and changes in the tax laws regarding charitable deductions. The majority of the examples of unfair competition seen by the BCFC have little to do with these Federal policies; the tax-exempt entity is simply looking for a way to make money.

A recent article by Judson Bemis, Chairman of the Alpha Center for Public/Private Initiatives offers an alternative to the often-heard argument: if nonprofits have to cut back on their charitable activities because of restrictions on their commercial activities, then the Federal government will be forced to provide these services. Mr. Bemis debunks the traditional assumption that human services can be delivered only by nonprofits or government. There is a third alternative--

provision of human services by tax-paying, for-profit businesses. Critics claim it is not possible to mix compassion with profits, that the profit motive means a reduction in quality, and that people in need of services won't be able to afford them. Mr. Bemis makes this point, "Profits are necessary to keep the grocery stores, the carpenters and the department stores in business. They are the source of new products, new jobs, new ways to provide services. Profits are no more the purpose of a business than breathing is the purpose of life. Breathing is a requirement of life."

There is no organized body of law or economics to explain adequately why nonprofits exist or why governments grant such status to particular enterprises. As early as 1601, the British had conferred preferred status on charitable institutions through the Statutes of Uses. In the U.S. the first tax exemptions surfaced in the Tariff of 1894. Since that time Congress has added over 25 specific statutory categories but "not [as] the result of any planned legislative scheme, and [exemptions] have never been set forth as part of any unified concept of exemption."

Academicians have advanced a number of theories to explain the existence of nonprofits. The predominant explanation is the contract failure theory, which states that a consumer "needs an organization that he can trust, and the nonprofit, because of the legal constraints under which it must operate, is likely to serve that function better than its for-profit counterpart."

A second theory is the "public good" theory, which suggests that nonprofits provide services the government would otherwise have to provide to the citizenry. Both the Congress and the courts have provided added credibility to the theory. Small business counters with the assertion that the public good rationale actually begs the question. The existence of for profits should be prima facie evidence that the government would not have to provide the service. Further, one can ask why the Government does not subsidize all providers, whether for-profit or nonprofit.

One rationale for tax exemption is that it fosters volunteerism and the principle of volunteerism is part and parcel of our society and culture. What makes the U.S. economy truly unique is the balance between self-reliance and the common good. However, tax exemption does not have an inherent bearing on the relationship. Nonprofit status without the tax exemption should foster volunteerism under this theory. The motivation of the volunteer, in addition to the desire to contribute to the common good, is the knowledge that no individual will benefit or profit from the work of volunteers.

In testimony before the Ways and Means Subcommittee last

June, Professor Henry Hansmann applied the measure of efficiency to his support for a new way of treating nonprofits:

> 1. It is quite possible that nonprofits will often manage unrelated businesses less efficiently than for-profit firms. Tax exemption allows nonprofit firms to survive in competition with for-profit firms, even when the nonprofits operate at a higher cost;
>
> 2. In the absence of UBIT, nonprofits would have an incentive to under-diversify their investments, investing, for example, in wholly owned businesses, rather than in a broad range of common stocks;
>
> 3. Tax exemption for unrelated business activities is a form of subsidy for nonprofits that is poorly proportioned to their needs;
>
> 4. Without the UBIT, nonprofit organizations might face an excessively strong incentive to invest in unrelated businesses, rather than in production of the services for which they are principally organized, and might augment the tendency of nonprofits towards acquiring excessive financial reserves; and
>
> 5. Without the UBIT, difficult and arbitrary judgments would have to be made as to when the volume of unrelated business activity becomes so large that the organization's tax exemption could be withdrawn.

Hansmann traced the historical evolution of nonprofit organizations in the service industries. Generally these nonprofit organizations, assisted by substantial philanthropic funding, played an important role in the beginning, the stage where for-profit firms (due to the problems of market failure) were not viable. As these industries matured, technology, financing and information developed, and for-profits performed all these functions adequately. These mature service industries (for example, hospital industry, nursing care, day care, fitness centers) are heavily populated by nonprofit firms. But the nonprofits seem to play "no special role." He noted that some clearly offer uncompensated services to the public and the poor and these do deserve a tax exemption.

Gabriel Rudney from Yale University declared that the accelerated expansion of commercialization threatens the very existence of the nonprofit sector and their donative role. He testified:

> Commercialization activities are so extensive in nonprofits they actually threaten the primary purpose for the tax exemption.

In terms of competition, Rudney said:

> The public has the opportunity to exercise choice among commercial products or services offered by nonprofit business and for-profit business without government intervention by tax subsidy.

Competition can come from all sides. An example of government competition exists with the Federal laboratories. These laboratories have developed a consortium that is aggressively marketing their services to industrial clients. The vast majority of these services are available from tax-paying private businesses, most of them small businesses. Ironically, certain elements of Congress are encouraging more of this. Here we not only have government competition, but the Congress encouraging that competition.

Another startling example of government competition comes from the Learning through Media Coalition. This coalition has reviewed a plan by the Public Broadcast Service, a nonprofit organization, to provide schools all over the country with "instructional technologies to meet educational needs." These technologies would include PBS supplying equipment, creating and selling videocassettes, conducting research and providing television programming through its existing communications network. Government funding would allow this massive expansion to occur at the expense of small, private companies fully capable of providing these services to their local school systems.

Although the BCFC is greatly appreciative of all the recent attention by the Congress to the UBIT problem, we feel that in addressing that area, we are really only dealing with the tip of the iceberg. As we related in our testimony, the advantages that are available to tax-exempt organizations are numerous. All aspects of the nonprofit unfair advantage need to be closely examined and inappropriate activities must be stopped.

We respectfully suggest that the Committee request the Small Business Administration to conduct a study to look into these various areas more closely. We are aware that the Office of Advocacy has had this on their "request for proposals" list in the Economic Research Division. We feel that a Report on this subject deserves an even broader and better-funded approach than has been done previously.

All sides of the issue agree that lack of adequate data is part of the problem. We encourage the Internal Revenue Service to radically modify its Form 990 and 990T. Proper enforcement requires that changes to these forms be made in the near future. Currently, the forms do not supply sufficient information about the types of activities in which the nonprofits are engaged, nor do they identify the relationship between the nonprofit and its commercial subsidiaries. Better data collection will benefit both the small business and nonprofit communities, as well as the Federal Government.

In the UBIT area we agree with the academic solutions of Mr. Hansmann in suggesting that it might be appropriate to consider more restrictive criteria for exempting organizations that are primarily commercial in nature. An approach might be to deny tax exemption to nonprofit firms in service industries in which for-profit firms also have a substantial market share, the exception being the case where they provide charitable services free or below cost to the poor, or uncompensated services that clearly benefit the public at large. Hansmann and BCFC support the suggestion that nonprofits have the burden of showing that they perform a socially important role that is not performed by for-profit firms; otherwise, they should not be exempt.

BCFC proposes that we look first at "how" an activity is conducted. As one Congressman was quoted as stating during debate on the 1986 Tax Reform Act: "If they quack like a profit-making entity and waddle like a profit-making entity, they should be taxed like a profit-making entity." We cite this quotation in all seriousness because it captures the essence of the problem. In 1987, too many activities of nonprofits have all the characteristics of a commercial venture, but few of the economic responsibilities. We need to bring nonprofit commercial activities into the light and apply to them the standard by which all competitors in the marketplace are regulated. We grant the fundamental change in the treatment of "charitable endeavors" that underlies this proposal, but we believe that many activities (not purposes) of many nonprofits no longer can be characterized as "charitable endeavors." If a charity pays taxes on the revenues of commercial activities and forgoes other nonprofit privileges, such as the lower postal rate, it is still able to use after-tax revenues to support its charitable endeavors.

While we are discussing solutions to the problem of unfair competition, we would like to point out that the BCFC has a committee to pursue this issue at the state level. We are pleased at the legislative initiatives being undertaken in many of the states and would like to point out several of them.

- Two states, Colorado and Iowa, have passed bills limiting the commercial activity of government agencies and providing for grievance procedures for small businesses affected by such commercial activity.

- Numerous states have passed resolutions calling for studies on unfair competition.

- Task Forces have been set up to coordinate study and solution of this problem throughout the country.

Attached to this statement is the most recent BCFC report on state developments.

Reliance on the private sector was a guiding precept for our founding fathers. When ambiguity and doubt begin to obscure the role of the government, as it has in the subsidization of the nonprofit sector, we must return to the simple but essential doctrine upon which our economy is founded -- reliance on the private tax-paying sector. Thank you for your consideration, Mr. Chairman.

Business Coalition For FAIR COMPETITION

COALITION PARTICIPANTS - 1988

American Association of Nurserymen
American Association of Small Research Companies
American Blood Resources Association
American Consulting Engineers
American Council of Independent Laboratories
American Orthotic & Prosthetic Association
American Society of Travel Agents
American Veterinary Medical Association
Arizona Search Consultant Association
Association of Data Processing Service Organizations
Association of Indoor Recreational Facilities of VA
Association of Physical Fitness Centers
Business & Associations for a Strong Economy
Health Industry Distributors Association
Information Industry Association
International Communications Industries Association
International Racquet Sports Association
National Association of Chain Drug Stores
National Association of Medical Equipment Suppliers
National Association of Retail Druggists
National Federation of Independent Business
National Hearing Aid Society
National Office Products Association
National Tour Association
Professional Services Council
Small Business Legislative Council
Textile Rental Service Association
United Bus Owners of America
U.S. Chamber of Commerce

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STATE-BY-STATE SUMMARY

In the past two months, two states, Colorado and Iowa, have passed bills limiting the commercial activity of government agencies and providing for grievance procedures for small businesses affected by such commercial activity. In addition, the state of Virginia has passed a statute which calls for a survey of hospitals to determine the extent of their commercial diversification. In a similar vein, a bill has been introduced in the state of Pennsylvania, to collect data on the nonprofits and to determine the extent of their commercial activity. The state of California is conducting a legislatively mandated study of the impact of the growth and effect of the commercializaton of the nonprofits. The states of Washington, Wisconsin, and Ohio were able to pass resolutions calling for studies of specific aspects of unfair competition. In the state of Louisiana a number of bills on unfair competition have been introduced.

The state of Texas has a formally organized Coalition and two states, Montana and Wyoming have informal coalitions working on unfair competition. In Minnesota, Michigan and Nebraska there are private studies being conducted.

The activity in the states is varied and diverse. The following is a more detailed summary of these recent developments.

ALABAMA

Two bills which the Coalition opposed did not pass.

- S.B. 281 (introduced by Senator Ann Bedsole) allowed non-profits to purchase goods and services from the department of corrections.
- H.B. 36 (introduced by Representative Claude Walker) authorized the Department of Corrections to contract with industry on joint ventures with inmate labor.

Our thanks to Cherie Colquett of NFIB (205/264-2261) for this good news.

ARIZONA

Kirby Garrett of NFIB reports that H.B. 2405 which would have given the Private Enterprise Review Commission cease and desist powers did not pass this session. The Arizona Legislature, as you may remember, was involved in an impeachment process. Garrett says that the legislation will be worked on and the bill will be redrafted. Garrett can be reached at 602/254-1541.

H.B. 2181 introduced by Mark Killian also did not pass this session. This bill provided for financial disclosure from publicly supported non-profits (other than religious organizations). Some of the reporting requirements of the bill included:

- A statement of income, expenses and disbursements for the year

- A balance sheet showing assets, liabilities and net worth
- Total amount of contributions from state, subdivision of state, or the Federal government
- A copy of the most recent tax return

The publicly supported corporation would also have been required to report to the Corporation Commission whenever it transferred capital assets or made any financing arrangements with a for-profit affiliate of the publicly supported corporation.

Representative Mark Killian can be reached at 602/255-5729.

BCFC has copies of both bills.

CALIFORNIA

The Advisory Task Force on Competition Between Nonprofit Organizations and Small Business, created as a result of the passage of A.B. 944, held its first public meeting on April 1. Ken Gibson, Director of the Department of Commerce, is chairman of the Task Force. On the Task Force are representatives of small business and the nonprofit sectors.

Alice Gallagher Reed, of the California Business Coalition, says that the Task Force hopes to produce a report that will contain the hard facts and statistics of the unfair competition problem, including an overview of the income capabilities of the nonprofits, the amount of Unrelated Business Income Tax paid in the state, and an assessment of current state laws to determine their adequacy in prohibiting unfair competition.

The next meeting of the Task Force will be held in Sacramento on May 20. The Task Force will hear testimony from the Board of Equalization and Franchise Tax, the County Tax Assessors Association, the Attorney General's Office, the Secretary of State, Charitable Trusts, the IRS, and representatives from the U.S. Treasury, nonprofit, and for-profit organizations.

A number of public hearings have been scheduled including:

- June 24th in San Francisco
- July 14th in the Los Angeles area
- August 9th at a site to be determined

For more information call Alice Gallagher Reed at 800/648-1611 or 415/581-1627.

COLORADO

H.B. 1009 passed the Colorado Legislature and has been signed into law. Congratulations to the Colorado Coalition for Fair Competition!

As reported previously, the bill originally included state agencies, universities, and non-profits, but, as passed, restricts the commercial activities of state agencies and universities.

Complaints against the commercial activity of state agencies are heard by the Advisory Board to the Office of Regulatory Reform. The Board may hold a public hearing to decide if the state agency is in violation of the Act and the Board is to report its activities annually to the Governor, the General Assembly, and the State Auditor.

The Act provides that the Governing Board of each public (only public universities are subject to the law) institution of higher learning adopt procedures for hearing complaints in accordance with the guidelines developed by the Colorado Commission on Higher Education (CCHE). The CCHE is to report annually on the implementation of the complaint procedures to the Governor and the General Assembly.

Governor Roy Romer signed the bill on April 22, 1988 at 3:52 P.M.

Colorado also passed S.B. 40 concerning correctional industries. We have not yet received a copy of the bill as passed and will report on its provisions in our next upadate.

Contacts in Colorado are Ron Smith of NFIB at 303/534-1631 and Pat Davis at 303/933-0932.

GEORGIA

As reported previously, the Georgia Senate passed S.R. 384 (introduced by Senator Bud Stanbaugh) which created a Senate Government Competition with Private Enterprise Study Committee. As of this date, Lieutenant Governor Zell Miller has not yet appointed the members of this study committee.

S.B. 630, introduced by Senator Roy Barnes and Senator Floyd Hidgins prohibits local governments from entering the electronic security business. The bill was supported by the Georgia Burglar and Fire Alarm Association, Inc. and the National Burglar and Fire Alarm Association. It was opposed by City of Conyers, Georgia Municipal Association and the Association of County Commissioners of Georgia. The city of Conyers, it should be pointed out, operates Conyers Security Alert which sells and installs electronic security equipment to the general public.

The bill was subsequently amended to exclude the city of Conyers and was passed and signed into law on April 12, 1988.

However, the problem still remains and the Georgia Burglar and Fire Alarm Association has filed a notice of suit against the city of Conyers. Previous to the introduction of legislation and the filing of the suit the GBFAA attempted to solve the problem with the city of Conyers over a period of twenty months.

Contact on this issue is John H. Thomas, Executive Director of the Georgia Burglar and Fire Alarm Association at 404/448-0581 or 447-5611. His address is Bldg. 2400, 3000 Langford Road, Norcross GA 30071.

IDAHO

H.B. 496, a licensing and regulatory bill for hearing aid dealers and fitters, was passed and signed by the governor. The bill, as signed into law, contains a provision that prohibits government agencies and nonprofits from selling hearing aids for profit.

However, the law was drafted to allow the Elks Rehabilitation Hospital to continue selling hearing aids, and could permit other hospitals, who might be able to meet the requirements of the law, to sell hearing aids. NFIB's Pete Skamser notes that it would be difficult for other hospitals to meet the requirements of the law. Jack Warberg of the Idaho Hearing Aid Society says that this a hard won victory for the hearing aid dealers in Idaho. Skamser can be reached at 208/343-3289 and Warberg at 208/733-0601.

ILLINOIS

Representative Richard Mautino's bill, H.B. 3277, creating a Private Enterprise Review Board did not make it out of committee. The duties of the Board are to:

- Study the economic activities of state government which are usually reserved for the private sector
- Measure the cost of public subsidies and treatment of not-for-profit entities in relation to loss of tax dollars
- Act as registry for complaints by business against state and not-for-profits agencies

The possibility remains, according to Joe Handley, that the bill can be amended on to another bill that did make it out of committee. Joe can be reached at 217/782-5456. BCFC has a copy of this bill.

INDIANA

No meeting dates have been set for the Interim Study Committee, chaired by Senator Joseph Cororan. The Study Committee will be taking up the problems of unfair competition and privatization. Senator Cororan can be reached at 812/522-5987.

Another contact in Indiana is NFIB's Ed Bowman at 317/638-4447.

IOWA

H.F. 529, which prohibits state agencies or political subdivisions from competing with private enterprise, passed the Iowa Legislature on April 6, 1988 and was signed by the governor on May 12, 1988. Congratulations to the Iowa Coalition for Fair Competition!

The bill, similar to the Arizona statute, does not set up any review commission, but rather places the investigatory powers in the Office of the Citizens' Aide. Any aggrieved person may seek relief by filing suit in the district court where the aggrieved person's business is located.

The bill also has a section on local services which requires a "city, county, area education agency" to purchase locally "if the cost and other considerations are relatively equal."

Paul Woodard of the Iowa Hearing Aid Society noted he "was proud of the work of Dave Brasher." He added that Brasher did an "outstanding job of guiding the bill through the legislature." Woodard can be reached at 515/255-2300. Dave Brasher of NFIB can be reached at 515/243-4723.

Two other bills, prohibiting area educational agencies from centralized buying and distribution of school supplies, did not pass this year. However, a coalition organized with the help of the National School Supply and Equipment Association in Iowa was able to get an amendment to the Appropriations Bill which would require the Legislative Fiscal Committee to do an interim study of the actual cost of current area educational agencies warehousing practices. Such an audit, the Association believes, will demonstrate that such purchasing practices provide no savings for the state, and provide the basis for the future passage of legislation that will prohibit centralized buying and distribution by the area educational agencies.

John Dolezal of the National School Supply and Equipment Association noted that the inclusion of the area educational agencies in the unfair competition bill, H.F. 529, is a help, but "doesn't do everything." John's phone number is 703/524-8819.

The Mayor's Task Force Report, "Tax-Exempt & Government Owned Property in Des Moines," is an excellent report which looks at the problem of tax-exempt property within Des Moines. The report contains the programs of some states and cities which have already addressed the tax-exempt problem, the pilot options considered by the Task Force, and the key points of agreement of the Task Force.

KANSAS

Although a majority of a five-person Board of Tax Appeals determined that the Topeka YMCA "had failed to show that it should be exempt from local ad valorem real estate and personal property taxes by qualifying as a charitable, educational, religious or scientific organization," the Kansas Legislature passed H.B. 2651 which specifically exempts the Ys from paying these taxes. The bill was signed into law on April 21, 1988. Our contact on the Y situation is Cathy Masterson of International Racquet Sports at 617/236-1500.

KENTUCKY

Although H.B. 636 which would have created a review board on the Arizona model did not pass the legislature this year, an interim group, the Small Business Task Force, co-chaired by Senator Fred Bradley and Representative Clay Crupper, is still in existence. The Task Force on Small Business will be meeting toward the end of the summer. Randy Bacon, Legislative Analyst, expects that the Task Force will be taking a series of field trips to a number of universities to view first-hand some of the problems of unfair competition. Randy can be reached at 502/564-8100.

A bill which permits the operation of prisons by private enterprise passed the Kentucky Legislature this session. We do not yet have a copy of the bill and will report on it in more detail at our next update. Contact in Kentucky is NFIB's Ed Bowman at 502/587-1113.

LOUISIANA

A number of bills are being introduced into the Louisiana Legislature which address the problems of unfair competition by nonprofit organizations and by the prison industries in Louisiana.

Leading the fight in Louisiana are ICIA member John Pace of Interstate Companies of Louisiana, Dr. Robert Flournoy of EnviroMed Laboratories, Inc. and member of the American Council of Independent Laboratories, and Harry Layne of American Building Specialties.

Senator Larry Bankston is introducing the following four bills:

- S.B. 564 -- prohibits competition between state agencies and private scientific testing labs
- S.B. 565 -- enacts the Private Enterprise Act
- S.B. 566 -- concerns goods made or produced by inmates of corrections institution
- S.B. 567 -- concerns the sale of goods from prison enterprises to state agencies

Representative Quentin Dastugue of Jefferson Parish and Representative Raymond Jetson of East Baton Rouge are introducing the following two bills:

- H.B. 1285 -- concerns the sale of prison-made goods to the public
- H.B. 1286 -- concerns the purchase of goods and services from prison enterprises by government agencies

We do not have copies of the above bills at this writing, but expect to have them in the near future. Contact on these bills is John Pace, who can be reached at 504/387-5131. John would welcome support from small business on these bills.

MARYLAND

S.B. 68, introduced by Senator Laurence Levitan, and which would have set up a Commission on Ecomony, Competence and Efficiency in State Government was defeated in the Senate Finance Committee. The Department of Budget and Fiscal Planning is pursuing its own study to save money in state government. Staff contact for Senator Levitan is Miles Schulman at 301/858-3169.

MICHIGAN

BASE (Businesses & Associations for a Strong Economy) met with James Sparling of Congressman Guy Vander Jagt's office on recommendations to solve the problem of competition from the nonprofits. Sparling urged the group to contact other U.S. Representatives and Senators and we think this is excellent advice not only for the people involved in BASE but for all BCFC members.

Marty Andrews, co-chairperson of BASE along with Steve Wagner, tells us that the BASE newsletter is now reaching approximately 800 people. One of the priorities of BASE in the coming months will the prison industries in Michigan. Marty and BASE can be reached at 517/374-0860.

Juanita Pierman of NFIB is leading an effort in the state to solve the unfair competition problem from the universities through the Small Business/Higher Education Forum. The Forum, originally called the Connection, was begun last September by Pierman, Glenn Stevens representing the universities, and Linda Siefka of the Small Business Association of Michigan. The group has had six planning meetings and the Forum now includes NFIB, the Small Business Association of Michigan, the Michigan Manufacturers Association, and the Michigan Retailers Association along with the representatives of the fourteen Michigan universities. Pierman can be reached at 517/485-3409.

Angel Bakos of the National Tour Association and the Michigan State Chamber of Commerce informs us of a number of developments in Michigan.

Hillsdale College, along with the State Chamber, is spearheading a privatization study in the state.

The Mackinac Center for Public Policy is funding a study by Dr. Van Eaton of Hillsdale College which will focus on the unfair competition from both the nonprofits and government.

As of this writing we have not had a chance to contact the people involved in the studies, but hope to have more information for our next update. Angel Bakos can be reached at 313/474-4800.

MINNESOTA

Members of the Joint Legislative Task Force to study unfair competition will not be appointed for another month or two, according to Mike Hickey of the Minnesota NFIB. The Joint Task Force plans to meet this summer and fall and report its findings to the 1989 session of the Minnesota Legislature.

The Citizens League, a private, non-profit research and educational organization based in the Minneapolis-St.Paul metropolitan area is studying the issue of taxes, with the intent of defining the criteria for tax-exemptions of the nonprofits and government.

Among the questions the group is looking at include:

- The cost of existing exemptions and the return to the public for granting the exemptions
- The way tax burdens would shift among individuals and groups of various incomes if exemptions were removed
- The impact on for-profit competitors when nonprofits or government are favored through exemptions
- The adequacy of the definition of exempt entities, including the use of such terms as "non-profit"

One of the problems experienced by the group is the lack of data, according to Marina Lyon, researcher for the League.

As soon as the League publishes its report we will let you know of its findings and how you can get copies of the report.

OHIO

SJR 20, introduced by Senator Cooper Snyder and 13 other co-sponsors, passed the Senate on March 10, 1988. The resolution sets up a Joint House and Senate Competition Study Committee to look into governmental activities in competition with the private sector and the desirability of contracting out.

The resolution is now in the House Economic Development and Small Business Committee where Mark Davidson of NFIB tells us that he does not expect any action until November when the legislature comes back into session. The resolution calls for four representatives from the private sector, but Mark expects the committee to be cut back to a purely legislative committee. Mark can be reached at 614/221-4107.

A Select Committee to Study Liquor Privatization will be holding hearings this summer on S.B. 255, introduced by Senator Roy Ray, which allows for the privatization of state liquor stores that fail to meet certain fiscal requirements. Tim Maglione of the Ohio Council of Retail Merchants is our contact on this issue and he can be reached at 614/221-7833.

MONTANA

J. Riley Johnson of NFIB informs us that he has been meeting with three groups in the state, the Solid Waste Management Association, Montana Printers Association, and the Crop Insurance Coalition, and they hope to form a coalition to support legislation on unfair competition. They are currently in the process of deciding what kind of bill to support (H.B. 593, creating a Private Enterprise Review Commission died in the last session of the legislature).

Johnson would like to have more support for the effort and he can be reached at 406/443-3797.

NEBRASKA

The Privatization Council of the Nebraska Chamber of Commerce and Industry will be holding its first meeting on May 23 according to Dan Vodvarka, staff vice president. One of the things the Council will be looking at is L.B. 1084, introduced by Senator Chris Abboud, which was modeled on the Arizona statute but defeated in the last legislative session.

Vodvarka's phone number at the Chamber is 402/474-4422.

NEW JERSEY

The Senate County and Municipal Government Committee, chaired by Senator Richard Van Wagner, is holding a series of public meetings to examine the current public contracting laws to see if any changes are needed. Contact is Hannah Shostack at 609/292-1596.

NEW YORK

Luke Rich of Senator Walter Floss' office is still hopeful that two of Senator Floss' unfair competition bills will see action this year.

He is most optimistic about S.B. 1797 which requires that state agencies and nonprofits that receive equipment or buy equipment with public money not sell any service that such equipment provides. This is modeled on NSF (National Science Foundation) guidelines. Rich hopes to see action on the bill next month.

The second bill that may see action is S.B. 1798 which allows local government to privatize water and sewer systems.

Luke can be reached at 518/455-3161.

PENNSYLVANIA

Representative Italo Cappabianca has introduced, along with 23 co-sponsors, H.B. 2344 which requires nonprofit corporations to supply information of their affiliation, activities, and tax status.

The bill requires the Department of Revenue to:

- Establish a data base of nonprofit corporations
- Determine the extent to which affiliations exist between nonprofit and for-profit entities
- Determine the level of commercial activity of nonprofit corporations and their affiliates
- Determine the fiscal impact of such activities on the Commonwealth's revenue

Our contact on this bill is Ida Stabinski of Representative Cappabianca's staff and she can be reached at 717/787-4358.

The Pennsylvania Chamber of Business and Industry is supporting Cappabianca's bill. Their Blue Ribbon Task Force on Nonprofit Competition states that:

> "A difficulty encountered by many bodies studying the relationship of nonprofits and tax exempt organizations to profit-oriented businesses is the lack of information concerning the activities of nonprofits and tax-exempt entities. The public is entitled to reasonable information concerning the activities of such organizations. The General Assembly should enact legislation of general application requiring reasonable periodic reporting by nonprofit and tax-exempt organizations on their finances and structure."

Our thanks to Jeralyn Smith of the Chamber for a copy of this report. The Chamber's number is 717/255-3251.

TEXAS

The Texas Coalition for Fair Competition will hold its next meeting on May 25th at the Texas Pharmaceutical Association, 1624 East Anderson Lane, Austin. For information on the meeting and the time of the meeting call the Chairman of the Coalition, Robert Stluka at 512/476-9847.

Stluka says that the Coalition has picked up more support groups and now hopes to start drafting legislation and seek out legislative sponsors.

VIRGINIA

The Virginia Legislature passed a number of bills addressing specific aspects of unfair competition:

H.B. 1058 requires the Hospital Cost Review Council to survey all hospitals in the Commonwealth that report to the Council to determine the extent of their commercial diversification. The survey information is to include:

- the total assets; revenues; net profit after taxes, or if not-for-profit, its excess revenues; and the net equity, or if not-for-profit, the fund balance of each hospital and hospital holding company;
- the date of affiliation; nature of the affiliation; the method by which each affiliate was acquired or created; and the tax status of each affiliate and if tax-exempt, its Internal Revenue tax exemption code number for each affiliate of each hospital or holding company.

The results of the survey are to be reported annually, by December 1, to the General Assembly.

H.B. 1079 requires a hospital, which has an interest in a facility that engages in providing other out-patient health-related services, when referring patients for services, appliances or devices, to give the patient or the patient's representative, notice in "bold print," that these services, appliances, or devices may be available from other suppliers in the community.

Violations of this law are subject to a civil fine not to exceed $1000 and damages need not be proved.

H.B. 1078, which is similar to the above bill, requires all practitioners "of the healing arts" also to provide in "bold print" a notice that discloses "any known material financial interest of or ownership by the practitioner in such facility or entity," and that the services, appliances, or devices may be available from other suppliers in the community.

Violation of this section is also subject to a civil fine of $1000 and damages need not be proved.

WASHINGTON

Senators Eleanor Lee, Janice Niemi, Ann Anderson, and Mike Kreidler were appointed to the Senate Select Committee to investigate the causes of unfair competition from an historical perspective. This committee is the result of the passage of S.R. 8757 sponsored by Senator George Sellar.

Also appointed to the Select Committee was Robin Holm, President-Elect of the National Hearing Aid Society. The remaining members of the Select Committee have yet to be announced. The Select Committee is to report its findings and recommendations by January of 1989.

Contacts in Washington are Robin Holm at 206/682-3185 and Collins Sprague of the Association of Washington Business at 206/943-1600.

WYOMING

Jane Thomas of Wyoming Analytical Laboratories and member of the American Council of Independent Laboratories says that the informal coalition in Wyoming is in the "educate the legislators mode." She says that they are trying "to make sure that legislators know there is a problem."

H.B. 54, introduced by Representative Craig Thomas, is being rewritten for introduction into the next legislative session.

Contacts in Wyoming include Jane Thomas at 307/742-7995, Dick Oates of AOA Computers at 307/745-4670, and NFIB's Ray Lansing at 307/778-4045.

WISCONSIN

Wayne Corey of the Wisconsin Independent Businesses says that a decision will be made by the end of the month whether the Legislative Council will conduct a study on the impact of the prison industries. A.J.R. 76, a non-binding resolution calling for such a study was passed by the Legislature and Corey is hopeful that the study will be conducted.

A proposal to piggyback the Federal Unrelated Income Tax to the Wisconsin Income Tax is contained in the Budget Bill passed by the Legislature according to Douglas O. Johnson, vice president of the Wisconsin Merchants Federation and Executive Secretary of the Wisconsin Alliance of Hearing Professionals. Unless the governor uses his line item veto, the proposal will become law.

Johnson says that the next focus of attention will be the property tax in Wisconsin. A new property tax assessment manual is being written and Johnson feels that this is a good time to look at the exemptions of the nonprofits and various other issues.

Johnson can be reached at 608/257-3451.

SUMMARY

This summary demonstrates the major directions of state unfair competition activity:

- Establishment of coalitions -- both formal and informal
- Introduction and passage of laws that deal with specific and general aspects of unfair competition
- Introduction of laws that attempt to establish a data base of the revenue generating activities of the nonprofits
- Studies, both legislatively and privately conducted, on unfair competition and its effect on small business
- Studies looking at the tax-exemptions of the nonprofits

Perhaps the most significant trend is the willingness to look at the economic impact and costs (in tax dollars) of the economic activity of the nonprofits. Such data will not only provide for public accountability by the nonprofits, but will also provide a means of demonstrating the true nature of unfair competition in actual costs to the taxpayer.

Finally, I'd like to thank all of you for your help in putting this summary together. Because this report was written under time constraints, it is possible that there may be some omissions or inaccuracies. If we have left out any pertinent information, or if there are any inaccuracies in this report, please call us at 703/273-7200 or write to us at 3150 Spring Street, Fairfax, Virginia 22031-2399. We welcome your interest and your help.

TESTIMONY
OF
INDEPENDENT SECTOR

Presented By
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* Chairman, INDEPENDENT SECTOR Task Force on the Unrelated Business Income Tax

Before the
Committee on Small Business
U.S. House of Representatives

Hearings on
Competition Between For-Profits
and Not-For-Profits

June 29, 1988

INDEPENDENT SECTOR
1828 L Street, N.W.
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SUMMARY OF INDEPENDENT SECTOR RECOMMENDATIONS

INDEPENDENT SECTOR's recommendations include:

-- Computerizing and reporting the entire first page of the IRS Form 990 for exempt organizations and the Form 990-PF for private foundations.

-- Authorizing the Bureau of the Census or the Internal Revenue Service to report data from the first page of Form 990.

-- Authorizing the Bureau of the Census to include questions on nonprofit employment and volunteer activities in its Census of the United States.

-- Authorizing the Bureau of the Census to collect a Census of Service Industries every five years which includes a breakdown between for-profit and nonprofit service organizations using a complete service industry universe.

-- Authorizing the Bureau of the Census to collect data from the County Business Patterns annual study which separates for-profit from nonprofit organizations using FICA and Treasury records.

INDEPENDENT SECTOR supports the House Ways and Means Oversight Subcommittee's recommendation regarding the disclosure of nondeductibility of certain payments to charitable organizations. The Oversight Subcommittee is urging the full House Ways and Means Committee to consider requiring charities to make conspicuous and clear disclosure of applicable limits on deductibility of payments to them.

The House Ways and Means Oversight Subcommittee also discussed the importance of reviewing the unrelated business income tax law every five years. INDEPENDENT SECTOR has not taken a position on that issue, but such action probably would be supported by the nonprofit community.

FULL TESTIMONY OF INDEPENDENT SECTOR

I am Mathew Ahmann, Associate Director, Government Relations of Catholic Charities USA, and chairman of INDEPENDENT SECTOR's Task Force on the Unrelated Business Income Tax. I am also a member of INDEPENDENT SECTOR's Government Relations Committee. INDEPENDENT SECTOR is a membership organization of 650 nonprofit organizations, foundations, and business corporations. These organizations in turn represent hundreds of thousands of 501(c)(3) organizations in this country. This diverse membership is banded together to strengthen our national tradition of giving, volunteering, and not-for-profit initiative. A list of our members is attached (see Attachment #1).

The vast majority of nonprofits are small, locally-based groups which look to the small business community to provide volunteer leadership for their boards of directors and for their program activities. Therefore, we are very concerned about the question of unfair competition raised by some segments of the small business community. We welcome the opportunity to present testimony on the issue and will address the principal objectives of the hearings as stated in the June 23, 1988 press release. Those objectives are:

1. Identify the tax exemptions and other benefits to which nonprofit organizations are entitled and explore how

those benefits provide a competitive advantage in the marketplace.

2. Examine the reasons for the growth in income-producing activities of the nonprofit sector.

3. Identify the industries and types of activities in which unfair competition by nonprofit organizations and government enterprise is perceived to have the greatest impact on small business.

4. Explore policy options to address the problem of nonprofit and government competition with for-profit businesses.

To address these points, it is necessary to review the rationale for tax exemption for nonprofit organizations. Charities have been granted exemptions from federal income taxes since the adoption of the first federal income tax in 1913. The current federal tax exemption is granted under section 501(c)(3) of the Internal Revenue Code for a broad range of charitable public service activities, including "religious, educational, charitable, scientific and literary organizations and those testing for public safety, fostering certain national and international sports competitions or prevention of cruelty to children and animals."

The legislative history states that "exemption from taxation of money or property devoted to charitable and other purposes is based on the theory that the government is compensated for the loss of revenue by its relief from financial burden which would otherwise have to be met by appropriations from public funds and by the benefits resulting from the promotion of the general welfare." H.R. Rep. No. 1860, 75th Cong., 3d Sess. (1938). This statement acknowledges the historic partnership between government and nonprofit organizations to provide for the general welfare.

It is clear from the foregoing that government policies such as tax exemption, subsidized postal rates, and the encouragement of charitable contributions through tax deductions are policies that this government has followed for as long as 75 years as a means of encouraging nonprofit organizations to provide goods and services for the purpose of serving the public good.

The Committee has raised the question about the competitive advantage nonprofit organizations have because of their tax status. In addition to that question, we also urge the Committee to examine tax policy, as well as other government policies which support the growth of small business. Information from a 1985 report indicates that these tax advantages and other federal benefits are substantial.

> "The Small Business Administration (SBA) gives substantial benefits to small business. The SBA guarantees loans to small businesses that cannot obtain ordinary bank loans. The set-aside program permits only small businesses to compete for certain federal contracts, and the Office of Advocacy promotes the interests of small businesses. Some of these programs disadvantage nonprofit organizations or prohibit them completely from competing for government contracts."[1]

As a result of numerous provisions in the tax code, many commercial providers of social service pay little or no corporate income taxes.

-- "Only 46 percent of the businesses in this category had any net income after deductions.

-- "One-third of the net income was reported by S corporations and, therefore, was exempt from corporate income taxation.

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[1] The Myth of Unfair Competition by Nonprofit Organizations: A Review of Government Assistance to Small Business, A Report to Family Service America and The National Assembly, October 1985.

-- "Net taxable income for all corporations in the human services category equaled only two percent of their gross receipts and the net tax paid (after credits) amounted to only .026 percent of their gross receipts."[2]

It is impossible to know whether the foregoing tax advantages to small business total more, less, or are the same as the tax deductions for nonprofit organizations. That question warrants the Committee's attention.

The Committee on Small Business press release also requested that we address the issue of how benefits to nonprofits organizations provide a competitive advantage in the marketplace. From the foregoing, it isn't clear that nonprofits do have a competitive advantage in the marketplace and only anecdotal information has been presented to date to substantiate such alleged competitive advantage.

Perceived competition from nonprofit organizations clearly is a concern for some segments of the small business community, but it is not a vital concern for most small business owners. The publication, Small Business Problems and Priorities, by William J. Dennis, published by the Institute for Enterprise

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[2] Ibid.

Advancement in 1986 included a table entitled "Measures of Small Business Problem Importance, which listed 75 problem areas. The table indicated that the issue of competition from government or nonprofit organizations ranked 70th in importance out of 75 issues (see Attachment #2).

Perhaps the most important point is that nonprofits are not competing for advantage in the marketplace. They are in the "marketplace" for one reason and one reason only -- to serve the public interest. Throughout this debate on the issue of competition between for-profits and not-for-profits, there has been too little understanding of the differences between for-profits and not-for-profits and why those differences warrant tax exemptions and other government policies that support the work of nonprofits. Following is a list of several of those important differences:

1. Both For-Profit and Nonprofit Organizations Serve the Public Good But in Different Ways. The exclusive purpose of the nonprofit organization is to promote the public good. This purpose is fulfilled through activities such as education; conducting or promoting cultural, religious, or scientific activities; providing those in need with food, clothing, or shelter; fostering self-help; and, occasionally, advocating changes in public policy.

For-profit businesses are, of course, the underpinning of our national economy, providing the jobs and the tax revenue which make the American economy function. For-profit businesses which provide social services may serve the public good, but their principal purpose is to make a profit. This distinction is recognized by the U.S. Treasury regulation which states that, "an organization is not organized and operated exclusively for one or more of the purposes specified in Section 501(c)(3) unless it serves a public rather than a private interest."[3]

2. Nonprofit Organizations Do Not Have "Profits" in the Same Sense That Private Businesses Do. All private businesses, however public spirited, are run to produce a profit for their owners. By contrast, if a nonprofit has an excess of revenue over expenses, a relatively rare occurrence, the surplus must be used for the charitable purposes of the organization. Such surpluses are typically used both to cover deficits in other years and to subsidize free or reduced-cost services to low income people.

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[3] Treasury Regulation Section 1.501(c)(3)-1(d)(ii).

3. Nonprofit Organizations Which Engage in Business Activities Must Pay Federal Income Taxes On Those Activities. Nonprofit organizations must pay federal income taxes, at regular corporate rates, on all income-producing activities which do not contribute to accomplishing their exempt purpose. An activity of a nonprofit organization is subject to the so-called "unrelated business income tax" if it is: (1) a "trade or business," (2) "regularly carried on," and (3) not "substantially related" to the organization's exempt purposes. The expenses of carrying out a nonprofit organization's tax-exempt program cannot be used to offset taxable income.

4. A Large Body of Law Exists On The Subject Of Whether Income Earned By Nonprofits Is Subject To Federal Income Tax. As with all other federal tax issues, these determinations are made by the IRS, subject to review by the courts. Exempt organizations' returns are regularly audited by the IRS, and liability for unrelated business income tax is always subject to examination. Over the years, court decisions, IRS rulings, and determinations in individual cases have developed a very large body of law establishing which activities of nonprofits are sufficiently related to

the charitable purposes of the organization to be tax exempt and which activities are subject to tax.

5. For Valid Reasons, Nonprofit Organizations Have Increased Their Reliance On Sources Of Revenue Other Than Charitable Contributions. Most of the growth in income-producing activities has been in the area of fee for service. Nonprofits have charged fees for service from the time such groups were first established well over two hundred years ago. Fees for service help support the work of nonprofits and often subsidize services for low income people. In response to federal budget cutbacks and reduced tax incentives for charitable giving, nonprofits have increased their reliance on sources of support other than charitable contributions in order to maintain previous levels of services.

Between 1982 and 1988, federal spending in the areas of greatest concern to nonprofit organizations, exclusive of Medicare and Medicaid, declined a cumulative total of $100 billion compared to what would have been spent had FY-1980 levels been maintained.

6. It Is Not True That There Has Been A Major Trend Of Nonprofit Organizations To Enter Into, On A Tax-Exempt

Basis, Areas Traditionally Carried Out By For-Profit Businesses. In fact, the reverse is true. In many areas pioneered by nonprofits, such as exercise facilities, health care, homes for the aged, and a wide variety of social services, for-profits have begun competing extensively to provide services traditionally provided by nonprofit organizations. Many for-profit service providers which compete with nonprofits, particularly in the areas of home health care and day care, dominate their markets. Entry by for-profits into areas traditionally served by nonprofits has occurred primarily when third party payors (insurance companies or the government) ensure the financial viability of these activities, and where the market has grown to include a sufficient pool of consumers with the means to pay for services.

As of 1987, only six percent of total nonprofit human service agency income came from business activities and special fund-raising activities combined, and little change has occurred in recent years in that income according to research done at The Urban Institute by Carol J. Devita and Lester M. Salamon. These data were gathered from an examination of nonprofits in 13 communities throughout the nation.

7. Very Little Of The Annual Sources Of Funds Of Nonprofit Organizations Is From "Business" Activities. A myth is being repeated that there is $300 billion in taxable income in the nonprofit sector. That's not true.

The table below shows the total annual sources of funds of all nonprofit organizations:

TOTAL ANNUAL SOURCES OF FUNDS
OF THE INDEPENDENT SECTOR
Total: $300 billion

	Percent	Amount (in billions)
Private contributions	26.9%	$80.7
Government grants and payments	26.9%	80.7
Health service payments	24.0%	72.0
Tuition	12.0%	36.0
Investment income/Endowments	5.5%	16.5
Other dues, fees and charges	4.7%	14.1
	100.0%	$300.0

(Projected figures for 1986, based on 1984 data.)

For some organizations, a small part of the income listed after dues, fees, and charges -- which totals $14 billion -- is unrelated business income, and is therefore taxable.

8. Nonprofit Organizations Make Vitally Needed Social Services Available To Those Unable To Pay For Them. It is important to keep in mind that for-profits tend to "skim" affluent clients away from nonprofit service providers, thus creating a two-tier system of services

where the more affluent are served by for-profit businesses and lower income people are served by nonprofits. It seems clear that only the retention of federal income exemption by nonprofits will enable them to continue to provide free or reduced services to people of modest means.

Nonprofits provide a single system of care for all income groups, especially those who are geographically isolated, who are subject to discrimination, and who are expensive to serve. For-profits may offer some services to low paying or nonpaying clients, or those with severe long-term disabilities or other problems, but only in circumstances where the total service, over time, makes a profit.

9. Revenues Received By Nonprofits Increase The Accessibility Of Services To Low Income Individuals. Funds which nonprofits receive from people who can afford to pay the full cost for goods and services provided by nonprofits subsidize the provision of the same goods and services free of charge or at below-market rates to those who would not otherwise be able to afford them.

Nonprofit services such as fitness centers, homes for senior citizens, handicapped persons, and other health care facilities must be generally accessible, financially, to a significant segment of the community, according to federal law and regulations. For-profits are not subject to that requirement.

Conclusion

The Committee on Small Business has requested that we explore policy options to address the problem of nonprofit and government competition with for-profit businesses. We would like to make the following suggestions:

It is very clear that improved federal data collection is required to identify better the activities of the independent sector. A significant portion of our work involves research on the independent sector, and, over time, the inadequacies of federal data collection on nonprofit organizations have become painfully obvious to us. Sound quantitative analysis would allow the Committee on Small Business to determine more clearly the relationship between the nonprofit community and businesses, and to address properly difficult issues such as competition. We request the Committee on Small Business to support our recommendations to improve federal data collection on nonprofit organizations.

Our recommendations include:

-- Computerizing and reporting the entire first page of the IRS Form 990 for exempt organizations and the Form 990-PF for private foundations.

-- Authorizing the Bureau of the Census or the Internal Revenue Service to report data from the first page of Form 990.

-- Authorizing the Bureau of the Census to include questions on nonprofit employment and volunteer activities in its Census of the United States.

-- Authorizing the Bureau of the Census to collect a Census of Service Industries every five years which includes a breakdown between for-profit and nonprofit service organizations using a complete service industry universe.

-- Authorizing the Bureau of the Census to collect data from the County Business Patterns annual study which separates for-profit from nonprofit organizations using FICA and Treasury records.

We are very hopeful that the Committee on Small Business will urge the Bureau of the Census and the Internal Revenue Service to provide the foregoing information which will help provide data needed regarding income-producing and related activities of nonprofit organizations. We are pleased that the Oversight Subcommittee of the House Ways and Means Committee is supporting a number of provisions related to obtaining improved reporting.

We are also pleased that the Oversight Subcommittee has made a recommendation regarding the disclosure of nondeductibility of certain payments to charitable organizations. The Oversight Subcommittee is urging the full House Ways and Means Committee to consider requiring charities to make conspicuous and clear disclosure of applicable limits on deductibility of payments to them.

The House Ways and Means Oversight Subcommittee also discussed the importance of reviewing the unrelated business income tax law every five years. While we have not taken a position on that issue, it is my belief that such action would be supported by the nonprofit community.

We would also urge the Committee on Small Business to study the economic roles of each sector and how they relate to one another.

We worked with the House Ways and Means Oversight Subcommittee on the unrelated business income tax issue. While we do not support all of its recommendations, we acknowledge the very important role it is playing in examining income-producing activities of nonprofit organizations. We stand ready to work with the Committee on Small Business as well to help assure that good information is developed on which to base current and future recommendations.

ATTACHMENT #1

06/24/88

INDEPENDENT SECTOR VOTING MEMBERSHIP LIST

A Presidential Classroom for Young Americans
ACCESS: Networking in the Public Interest
AMVETS National Service Foundation
ARCO Foundation
ARROW, Inc.
AT&T Foundation
Aetna Life and Casualty Company
African Wildlife Foundation, Inc.
Aid Association for Lutherans
Alcoa Foundation
Allied-Signal Inc.
American Arts Alliance
American Association for Higher Education
American Association for the Advancement of Science
American Association of Fund-Raising Counsel, Inc.
American Association of Museums
American Association of University Women
American Citizens Concerned for Life
American Council for Judaism
American Council of Learned Societies
American Council on Education
American Dance Guild, Inc.
American Ditchley Foundation
American Farmland Trust
American Foundation for the Blind, Inc.
American Humanics, Inc.
American Leadership Forum
American Lung Association
American Public Radio
American Social Health Association
American Symphony Orchestra League
Americans for Indian Opportunity
Amoco Foundation, Inc.
Appalachian Mountain Club
Arthritis Foundation
Association for International Practical Training
Association for Volunteer Administration
Association of American Universities
Association of Art Museum Directors
Association of Governing Boards of Universities and Colleges
Association of Jesuit Colleges and Universities
Association of Science Technology Centers
Association on American Indian Affairs
The Atlantic Foundation Service Co., Inc.
B'nai B'rith International
Mary Reynolds Babcock Foundation
Bankers Trust Company
Bell Atlantic
Benton Foundation
Big Brothers/Big Sisters of America
Blandin Foundation
Borden Foundation
Boston Globe Foundation, Inc.
Botwinick-Wolfensohn Foundation
Boys Clubs of America
Otto Bremer Foundation
Brother's Brother Foundation
Brunswick Foundation, Inc.

AAFRC Trust for Philanthropy
ACCION International/AITEC
ARCO Chemical Company
ARCS Foundation
ASPIRA Association, Inc.
Accountants for the Public Interest
Affiliated Leadership League of and For the Blind of America
Aga Khan Foundation U.S.A.
Aid to Artisans, Inc.
Alliance of Independent Colleges of Art
Allstate Foundation
American Assembly
American Association for Museum Volunteers
American Association of Community and Junior Colleges
American Association of Homes for the Aging
American Association of University Students
American Cancer Society
American Committee on Africa
American Council for the Arts
American Council on Alcoholism
American Craft Council
American Diabetes Association, Inc.
American Express Foundation
American Fisheries Society
American Heart Association
American Institute for Cancer Research
American Library Association
American ORT Federation, Inc.
American Red Cross
American Stock Exchange, Inc.
American Women's Economic Development Corporation
Amigos de las Americas
Anschutz Family Foundation
Arca Foundation
Aspen Institute for Humanistic Studies
Association for Retarded Citizens of the U.S.
Association of American Colleges
Association of American University Presses
Association of Black Foundation Executives
Association of Hispanic Arts Inc.
Association of Junior Leagues, Inc.
Association of Voluntary Action Scholars
The Astronauts Memorial Foundation, Inc.
Avon Products Foundation, Inc.
BP America
Ball Brothers Foundation
Beatrice Foundation
BellSouth
Beverly Foundation
Bing Fund Corp.
Boeing Company
Boston Foundation
Bothin Foundation
Boy Scouts of America
Bread for the World Educational Fund, Inc.
Bristol-Myers Fund, Inc.
Brown Foundation, Inc.
Burroughs Wellcome Fund

Edyth Bush Charitable Foundation, Inc.
CARE
CEIP Fund, Inc.
CPC International, Inc.
California Community Foundation
Camp Fire, Inc.
Carnegie Corporation of New York
Carroll Center for the Blind
Catalyst
Catholic Charities USA
Center for Creative Leadership
Center for Women Policy Studies
Center to Prevent Handgun Violence
Chase Manhattan Bank, N.A.
Chevron U.S.A., Inc.
Child Care Action Campaign
Children's Aid International
Chorus America (APVE)
Christian Ministries Management Association
Citicorp/Citibank
Civic Education Foundation
Cleveland Foundation
Close Up Foundation
College Board
Colorado Trust
Committee for Food and Shelter
Community Foundation for Southeastern Michigan
Community Foundation of Greater Washington DC
Conservation Fund
Corning Glass Works Foundation
Corporation for Enterprise Development
Council for Aid to Education
Council for the Advancement of Citizenship
Council of Independent Colleges
Council on Economic Priorities
Council on International and Public Affairs
S.H. Cowell Foundation
Charles A. Dana Foundation, Inc.
Edwin W. and Catherine M. Davis Foundation
Deere and Company
Denver Foundation
Dole Foundation for Employment of Persons with Disabilities
William H. Donner Foundation, Inc.
Joseph Drown Foundation
Duke Endowment
Dyson Foundation
Eastman Kodak Company
Ecolab Inc.
Education Network for Older Adults
Enterprise Foundation
Epilepsy Foundation of America
Evangelical Council for Financial Accountability
Exxon Corporation
Family Service America
Federation of State Humanities Councils
First Non Profit Risk Pooling Trust
Ford Foundation
Foreign Policy Association
Bush Foundation
CBS Inc.
CODEL - Coordination in Development, Inc.
Cabot Corporation Foundation
Call for Action, Inc.
Capital Cities/ABC
Carnegie Foundation for the Advancement of Teaching
Carter Hawley Hale Stores, Inc.
Caterpillar Foundation
Center for Corporate Public Involvement
Center for Creative Management
Center for the Study of the Presidency
Champion International Corporation
Chesebrough-Pond's Inc.
Chicago Tribune Foundation
Child Welfare League of America
Children's Hospice International
Christian Church Foundation
Church Women United
Citizens' Scholarship Foundation of America
Edna McConnell Clark Foundation
Clorox Company Foundation
Coca-Cola Foundation
Colonial Williamsburg Foundation
Columbia Foundation
Commonwealth Fund
Community Foundation of Greater Greenville
Connecticut Mutual Life Insurance Company
Consortium for the Advancement of Private Higher Education
Coro Foundation
Council for Advancement and Support of Education
Council for American Private Education
Council of Better Business Bureaus/ Philanthropic Advisory
Council of Jewish Federations
Council on Foundations
Council on Library Resources, Inc.
Cystic Fibrosis Foundation
Dance/USA
Dayton Hudson Foundation
Defenders of Wildlife
Geraldine R. Dodge Foundation
Gaylord and Dorothy Donnelley Foundation
Herbert H. and Grace A. Dow Foundation
E.I. duPont de Nemours and Co.
Durfee Foundation
Earthwatch Expeditions, Inc.
Eaton Corporation
Education Commission of the States
Elderworks, Inc.
Environmental Law Institute
Equitable Life Assurance Society of the United States
Evangelical Lutheran Church in America
Maurice Falk Medical Fund
Federated Department Stores, Inc. Foundation
First Bank System Foundation
Food for the Hungry, Inc.
Ford Motor Company Fund
Forty Plus Educational Center, Inc.

06/24/88

INDEPENDENT SECTOR VOTING MEMBERSHIP LIST

Foundation Center
Foundation for American Communications
Foundation for Children with Learning Disabilities
Foundation for Exceptional Children
Foundation for Independent Higher Education
Foundation for Teaching Economics
Foundation for the Carolinas
Foundation for the Peoples of the South Pacific, Inc.
Freedom from Hunger Foundation
Fresh Air Fund
Friends Association for Higher Education
Fuller Foundation
Fund for Artists' Colonies
Fund for New Jersey
Fund for an OPEN Society
GTE Foundation
Gannett Foundation
General Conference of Seventh-day Adventists
General Electric Company
General Foods Corporation
General Mills Foundation
General Motors Foundation
General Service Foundation
Georgia-Pacific Foundation, Inc.
Wallace Alexander Gerbode Foundation
J. Paul Getty Trust
Giraffe Project
Girl Scouts of the U.S.A.
Girls Clubs of America, Inc.
Morris Goldseker Foundation of Maryland, Inc.
Goodwill Industries of America, Inc .
GrandMet USA, Inc.
Grantmakers in Health
Lucile & Robert H. Gries Charity Fund
Grotto Foundation
Grumman Corporation
Gulf + Western Foundation
George Gund Foundation
Alan Guttmacher Institute
Miriam and Peter Haas Fund
Walter and Elise Haas Fund
Evelyn and Walter Haas, Jr. Fund
Habitat for Humanity, Inc.
Hallmark Cards, Inc.
Luke B. Hancock Foundation
James G. Hanes Memorial Fund/ Foundation
Harris Foundation
Hartford Insurance Group Foundation
Hawaiian Foundation
Charles Hayden Foundation
Edward W. Hazen Foundation
Healing Community
William Randolph Hearst Foundation
Heublein Foundation
William and Flora Hewlett Foundation
Hillman Foundation, Inc.
Conrad N. Hilton Foundation
Hispanic Policy Development Project
Hitachi Foundation
Hoffmann-LaRoche Foundation
Hogg Foundation for Mental Health
Honeywell Foundation
Hospital Research and Educational Trust
Hudson Webber Foundation
Hunt Foundation
Huntington's Disease Society of America
Godfrey M. Hyams Trust
IBM Corporation
INTERPHIL (International Standing Conference on Philanthropy)
Independent Research Libraries Association
Institute for Journalism Education
Institute for Nonprofit Organization Management
Institute for the Development of Indian Law
Institute of Current World Affairs
InterAction (American Council for Voluntary International
International Association of Lions Clubs
International Assn. of Psychosocial Rehabilitation Services
International Christian Youth Exchange
The International Exchange Association
International Fund for Animal Welfare
International Paper Company Foundation
International Primate Protection League
International Women's Health Coalition
Interracial Council for Business Opportunity
James Irvine Foundation
Ittleson Foundation
JWB
Jerome Foundation
George Frederick Jewett Foundation
Johnson & Johnson
Johnson Foundation, Inc.
Robert Wood Johnson Foundation
Joint Action in Community Service, Inc. (JACS)
Joint Center for Political Studies
Joint Council on Economic Education
Jostens Foundation, Inc.
Joyce Foundation
Junior Achievement Inc.
Henry J. Kaiser Family Foundation
W.K. Kellogg Foundation
Harris and Eliza Kempner Fund
John F. Kennedy Center for the Performing Arts
John F. Kennedy Library Foundation
Charles F. Kettering Foundation
Kmart Corporation
Knight Foundation
Kraft, Inc.
Kresge Foundation
Samuel H. Kress Foundation
Albert Kunstadter Family Foundation
Land Trust Exchange
League of Women Voters Education Fund
Sara Lee Foundation
Leukemia Society of America, Inc.
Lilly Endowment, Inc.
Eli Lilly and Company

06/26/88

INDEPENDENT SECTOR VOTING MEMBERSHIP LIST

Literacy Volunteers of America
Los Angeles Women's Foundation
Henry Luce Foundation
Lutheran Resources Commission
MATHCOUNTS Foundation/NSPE Education Foundation
Make-A-Wish Foundation of America
John and Mary R. Markle Foundation
Robert R. McCormick Charitable Trust
McGregor Fund
Meadows Foundation
Merrill Lynch and Company Foundation, Inc.
Metropolitan Life Foundation
Eugene and Agnes E. Meyer Foundation
Mobil Oil Corporation
Montgomery Street Foundation
Mothers Against Drunk Driving
Stewart R. Mott Charitable Trust
Mountain Bell Foundation
Mutual Benefit Life
Myasthenia Gravis Foundation
NOW Legal Defense and Education Fund
National 4-H Council
National Action Council for Minorities in Engineering
National Alliance for the Mentally Ill
National Assembly of Local Arts Agencies
National Assembly of State Arts Agencies
National Association for Hospital Development
National Association for the Advancement of Colored People
National Association of Homes for Children
National Association of Independent Schools
National Association of Private Schools for Exceptional
National Association of Rehabilitation Facilities
National Association of Schools of Music
National Association of United Methodist Foundations
National Audubon Society
National Bureau of Economic Research
National Catholic Development Conference, Inc.
National Charities Information Bureau, Inc.
National Civic League, Inc.
National Committee for Citizens in Education
National Concilio of America
National Congress of Parents and Teachers
National Corporate Fund for Dance, Inc.
National Council for International Visitors
National Council of La Raza
National Council of the Churches of Christ in the USA
National Council on Alcoholism, Inc .
National Dance Institute
National Easter Seal Society, Inc.
National Executive Service Corps
National Family Planning and Reproductive Health Association
National Fish and Wildlife Foundation
National Fund for Medical Education
National Gardening Association, Inc.
National Health Council
National Home Library Foundation
National Humanities Alliance
National Indian Youth Council

Local Initiatives Support Corporation
Lubrizol Foundation
Lutheran Brotherhood Foundation
Lyndhurst Foundation
John D. and Catherine T. MacArthur Foundation
March of Dimes Birth Defects Foundation
McAuley Housing Foundation
McGraw-Hill Foundation
McKesson Foundation, Inc.
Richard King Mellon Foundation
Metropolitan Atlanta Community Foundation
Mexican American Legal Defense and Educational Fund
John Milton Society for the Blind
Monsanto Company
Philip Morris Companies, Inc.
Mothers Embracing Nuclear Disarmament (MEND)
Charles Stewart Mott Foundation
Ms. Foundation for Women, Inc.
Mutual of America Life Insurance Company
NAACP Legal Defense and Educational Fund
NYNEX
National Academy of Public Administration
National Alliance for Research on Schizophrenia and Depression
National Alliance of Business
National Assembly of Nat'l. Vol. Health and Social Welfare
National Association for Bilingual Education
National Association for Visually Handicapped
National Association of College and University Business
National Association of Independent Colleges and Universities
National Assn. of Latino Elected and Appointed Officials
National Association of Public Television Stations
National Association of Schools of Art and Design
National Association of Schools of Public Affairs and
National Association on Drug Abuse Problems, Inc.
National Board for Professional Teaching Standards
National Catholic Conference for Interracial Justice
National Center for Urban Ethnic Affairs
National Child Labor Committee, Inc.
National Committee for Adoption, Inc.
National Committee for the Prevention of Child Abuse
National Congress for Community Economic Development
National Consumers League, Inc.
National Corporate Theatre Fund
National Council for Research on Women
National Council of Senior Citizens
National Council of Women of the United States
National Dance Institute
National Down Syndrome Society
National Education Association
National FFA Foundation
National Federation of Business and Professional Women's
National Foundation for Long Term Health Care
National Future Homemakers of America
National Headache Foundation
National Hispanic Scholarship Fund
National Hospice Organization
National Image, Inc.
National Institute for Dispute Resolution

National Medical Enterprises, Inc.
National Mental Health Association
National Neighborhood Coalition
National Network of Grantmakers
National Park Foundation
National Peace Institute Foundation
National Public Radio
National Puerto Rican Forum, Inc.
National School Volunteer Program, Inc.
National Society of Fund Raising Executives
National Sudden Infant Death Syndrome Foundation, Inc.
National Trust for Historic Preservation
National Urban League
Native American Rights Fund
New Haven Foundation
New York Community Trust
New York Times Company Foundation, Inc.
Northwest Area Foundation
Jessie Smith Noyes Foundation
OPERA America
Older Women's League
Outward Bound, Inc.
Pacific Telesis Group
Palm Beach County Community Foundation
People for the American Way
Pew Charitable Trusts
The Pillsbury Company
Pittsburgh Foundation
Planned Parenthood Federation of America
Population Council
Powell Family Foundation
Primerica Foundation
The Progressive Corporation
Public Affairs Council
Puerto Rican Legal Defense and Education Fund, Inc.
Quest National Center
RP Foundation Fighting Blindness
Raytheon Company
Reading is Fundamental, Inc.
Reinberger Foundation
Sid W. Richardson Foundation
Rockefeller Family Fund
Rockwell International
Rosenberg Foundation
Saint Paul Companies, Inc.
Salvation Army
Save the Children
Dr. Scholl Foundation
Scott Paper Company Foundation
Seaver Institute
70001 Training and Employment Institute
Sherwin-Williams Company
Sierra Club
Lois and Samuel Silberman Fund
Skidmore, Owings & Merrill Foundation
Alfred P. Sloan Foundation
Southern Education Foundation
Special Libraries Association
National Medical Fellowships, Inc.
National Multiple Sclerosis Society
National Neighbors, Inc.
National Network of Runaway and Youth Services, Inc.
National Parks and Conservation Association
National Psoriasis Foundation
National Puerto Rican Coalition, Inc.
National Retiree Volunteer Center
National Society for Internships and Experiential Education
National Society to Prevent Blindness
National Training and Information Center
National Urban Fellows, Inc.
National Wildlife Federation
Nature Conservancy
New World Foundation
New York Life Foundation
Nordson Foundation
Northwestern National Life Insurance Company
OICs of America, Inc.
Oakleaf Foundation
Open Space Institute
PPG Industries, Inc.
David and Lucile Packard Foundation
J.C. Penney Company, Inc.
Permanent Charities Committee of the Entertainment Industries
Pfizer Foundation, Inc.
Piton Foundation
Planetary Society
Polaroid Foundation, Inc.
Population Resource Center
Premier Industrial Foundation
Procter & Gamble Fund
Prudential Foundation
Public Service Satellite Consortium
Quaker Oats Company
RJR Nabisco, Inc.
Ray Foundation
Reader's Digest Foundation
Recording for the Blind
Charles H. Revson Foundation
Rockefeller Brothers Fund
Rockefeller Foundation
Rohm and Haas Company
Safeco Insurance Companies
Saint Paul Foundation
San Francisco Foundation
Schering-Plough Corporation
Scientists' Institute for Public Information
Scripps-Howard Foundation
Second Harvest
Shell Oil Company Foundation
Shubert Foundation
Sierra Foundation
Melvin Simon & Associates, Inc.
Skillman Foundation
John Ben Snow Foundation, Inc.
Southwestern Bell Foundation
Spencer Foundation

06/24/88 INDEPENDENT SECTOR VOTING MEMBERSHIP LIST

Spunk Fund, Inc.
Aaron Straus and Lillie Straus Foundation, Inc.
Student Conservation Association, Inc.
Sun Company, Inc.
Syntex U.S.A., Inc.
TRW, Inc.
Tandy Corporation/Radio Shack
Teachers Insurance (TIAA-CREF)
Telecommunications Cooperative Network
Texaco Philanthropic Foundation Inc.
3M Company
Transamerica Corporation
Trilateral Commission
UNISYS Corporation
USX Foundation Inc.
United Board for Christian Higher Education in Asia
United Negro College Fund
United States China Educational Institute
VOLUNTEER - The National Center
Visiting Nurse Associations of America
Volunteers of America, Inc.
Wain Foundation
Warner Communications Inc.
Washington Center
Weingart Foundation
Westinghouse Electric Corporation
Weyerhaeuser Family Foundation, Inc.
Amherst H. Wilder Foundation
Women and Foundations/Corporate Philanthropy
Women's Equity Action League (WEAL)
Woods Charitable Fund, Inc.
World Vision, Inc.
Wyman Youth Trust
YMCA of the USA
Zayre Corporation
W. Clement & Jessie V. Stone Foundation
Levi Strauss Foundation
Subaru of America Foundation
Support Center
TCF Banking and Savings, F.A.
Taconic Foundation, Inc.
Anne Burnett Tandy and Charles D. Tandy Foundation
Tektronix Foundation
Tenneco Inc.
Theatre Communications Group, Inc.
Time Inc.
Travelers Aid International
Trust for Public Land
USO World Headquarters
Union Pacific Foundation
United Jewish Appeal
United States Catholic Conference
United Way of America
Very Special Arts
Volunteer Trustees of Not-For- Profit Hospitals
Volvo North America Corporation
Izaak Walton League of America
Warner-Lambert Charitable Foundation
Washington Post Company
Wells Fargo Foundation
Weyerhaeuser Company Foundation
Mrs. Giles Whiting Foundation
Wildlife Preservation Trust International, Inc.
Women's Action Alliance, Inc.
Robert W. Woodruff Foundation
World Resources Institute
World Wildlife Fund/The Conservation Foundation
Xerox Corporation
YWCA of the USA
Zellerbach Family Fund

ATTACHMENT #2

Excerpt from: Small Business Problems and Priorities by William J. Dennis, Jr.
Published by Institute for Enterprise Advancement, 1986.

TABLE 1. Measures of Small Business Problem Importance

Problem Area	Rank	Mean	Standard Deviation	Median	Percent Critical Problem	Percent Not A Problem
Cost of Health Insurance	1	3.21	2.52	2.37	33	9
Cost and Availability of Liability Insurance	2	3.43	2.75	2.41	38	11
Cash Flow	3	3.81	2.66	3.14	28	10
Federal Taxes on Business Income	4	4.03	2.66	3.39	22	12
Telephone Costs and Service	5	4.05	2.48	3.47	17	10
Electricity Costs (Rates)	6	4.06	2.59	3.51	21	10
Workers Compensation Costs	7	4.27	3.03	3.37	30	20
Payroll Taxes	8	4.41	2.81	3.78	18	18
Federal Paperwork	9	4.57	2.81	4.16	17	17
State Taxes on Business Income	10	4.58	2.81	4.20	17	18
Interest Rates	11	4.59	2.76	4.37	17	16
Frequent Changes in Federal Tax Laws	12	4.64	2.79	4.46	18	17
Cost of Natural Gas, Gasoline, Fuel Oil	13	4.64	2.77	4.36	16	17
Poor Earnings (Profits)	14	4.71	2.83	4.65	19	16
State/Local Paperwork	15	4.82	2.65	4.64	12	16
Cost of Supplies/Inventories	16	4.86	2.61	4.70	11	16
Fixed Costs Too High	17	4.89	2.77	4.70	14	19
Competition from Large Businesses	18	5.11	2.92	4.52	15	23
Unreasonable Government Regulations	19	5.18	2.89	5.05	15	23
Highly Variable Earnings (Profits)	20	5.19	2.75	5.01	12	21
Delinquent Accounts/Customer Financing	21	5.19	2.86	5.00	13	22
Projecting Future Sales Changes	22	5.20	2.65	4.95	9	20
Locating Qualified Employees	23	5.31	2.95	5.13	14	26
Ability to Cost-Effectively Advertise	24	5.33	2.84	5.11	11	25
Controlling My Own Time	25	5.40	2.76	5.11	10	25
Frequency of Tax Withholding Deposits	26	5.52	2.88	5.28	11	29
Poor Sales	27	5.55	2.69	5.53	11	21
Pricing My Goods/Services	28	5.65	2.72	5.46	8	25
Keeping up on Business and Market Developments	29	5.78	2.50	5.58	5	22
Sales Too Dependent on Health of One Business or Industry	30	5.85	2.97	6.33	12	34

TABLE 1. Measures of Small Business Problem Importance (continued)

Problem Area	Rank	Mean	Standard Deviation	Median	Percent Critical Problem	Percent Not A Problem
Training Employees	31	5.94	2.68	6.08	6	30
Bad Debts (not delinquencies) and/or Bankruptcies	32	5.98	2.74	6.60	9	28
Local Promotion of Local Business	33	6.06	2.72	6.42	7	33
Finding Out About Regulatory Requirements	34	6.09	2.72	6.60	7	33
Sales Too Seasonal	35	6.14	2.68	6.63	7	32
Keeping Skilled Employees	36	6.15	2.78	6.89	8	34
Getting Useful Business Information	37	6.31	2.51	6.77	4	32
Obtaining Good Supervisory Personnel	38	6.31	2.84	7.41	7	41
Locating Business Help When Needed	39	6.33	2.61	6.95	6	34
Cost-Effective Mail Service	40	6.37	2.65	7.02	6	37
Cost of Government Required Equipment/Procedures	41	6.40	2.78	7.42	7	40
Controlling Inventory	42	6.40	2.64	7.10	5	38
Cost of Outside Business Help	43	6.42	2.57	6.62	4	36
Obtaining Long-Term (5 yrs. or more) Business Loans	44	6.44	-2.90	7.77	10	44
Handling Business Growth	45	6.46	2.51	6.99	4	36
Low Worker Productivity	46	6.50	2.50	7.12	4	35
Streets, Roads and Highways	47	6.50	2.69	7.51	6	39
Collecting Sales and/or Excise Taxes for Government	48	6.53	2.81	7.90	7	45
Getting Information on Government Business Assistance Programs	49	6.58	2.74	7.79	7	43
Applications for Licenses, Permits, etc.	50	6.58	2.64	7.58	6	41
Purchasing and Using Computer(s) Effectively	51	6.63	2.65	7.74	4	44
Employee Turnover	52	6.71	2.55	7.67	5	40
Anti-Competitive Practices, e.g., Price Fixing	53	6.75	2.68	8.00	7	45
Obtaining Short-Term (less than 12 months or revolving) Business Loans	54	6.76	2.77	8.22	8	47
Shoplifting, Pilferage, Bad Checks, Etc.	55	6.77	2.55	7.78	5	40
Changing Rules on Retirement Plans	56	6.79	2.65	8.12	5	46
Death (Estate) Taxes	57	7.00	2.70	8.57	7	54
Locating Satisfactory Suppliers	58	7.13	2.39	8.41	3	49
Competition from Imported Products	59	7.13	2.74	8.63	8	57
Street Crime	60	7.14	2.43	8.29	5	47

Excerpt from: Small Business Problems and Priorities by William J. Dennis, Jr. Published by Institute for Enterprise Advancement, 1986.

TABLE 1. Measures of Small Business Problem Importance (continued)

Problem Area	Rank	Mean	Standard Deviation	Median	Percent Critical Problem	Percent Not A Problem
Obtaining Investor (Equity) Financing	61	7.17	2.59	8.59	6	55
State/Local Inspections	62	7.21	2.40	8.53	4	51
Minimum Wage	63	7.34	2.39	8.61	4	56
Shipping or Receiving Shipped Goods	64	7.36	2.21	8.52	2	51
Parking or Public Transportation	65	7.37	2.48	8.66	4	59
Selling to State/Local Government	66	7.38	2.48	8.67	5	60
Federal Inspections	67	7.44	2.24	8.58	2	54
Selling to the Federal Government	68	7.46	2.46	8.70	4	62
Shortages of Materials, Goods, Fuel, etc.	69	7.50	2.17	8.57	3	54
Competition From Government or Non-Profit Organizations	70	7.52	2.37	8.67	4	60
Police and Fire Protection	71	7.52	2.20	8.59	3	55
Unattractive or Poor Business Location	72	7.53	2.21	8.62	3	57
Labor Unions	73	7.71	2.38	8.78	5	70
Disposal of Hazardous (Toxic) Waste	74	8.00	2.14	8.84	3	76
Exporting My Products/Services	75	8.22	1.90	8.87	3	79

NFIB

National Federation of
Independent Business

STATEMENT OF

JOHN J. MOTLEY III

DIRECTOR OF FEDERAL GOVERNMENTAL RELATIONS
NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Before: House Small Business Committee

Subject: Nonprofit and Government Competition

Date: June 29, 1988

Mr. Chairman, on behalf of the more than half million small business owners who are members of the National Federation of Independent Business (NFIB), I am pleased to be appearing before you today to discuss the issues of unfair competition from nonprofit organizations and the government with small businesses.

The issue of unfair competition with government entities and nonprofits was ranked third in a list of 60 recommendations developed at the 1986 White House Conference on Small Business. Our complex system of government subsidies provides certain organizations with tax and non-tax benefits which go far beyond original Congressional intent, and the combination of these tax and non-tax subsidies makes fair competition impossible.

Suite 700
600 Maryland Ave. S.W.
Washington, DC 20024
(202) 554-9000

The Guardian of
Small Business

COMPETITION FROM NONPROFIT ORGANIZATIONS

History

Congress has always sought to shield from taxation charitable, educational, and other types of nonprofit organizations. The Revenue Act of 1894 imposed a 2% corporate income tax on "corporations, companies, or associations doing business for profit in the United States." The act specifically exempted from taxation charitable, educational, and other entities which were not conducted as a business for gain.

With enactment of the first federal income tax in 1913, Congress once again provided exemptions for certain nonprofit organizations. In fact, the list of organizations which would be exempted was expanded, and the law specified that the corporate income tax would not apply to chambers of commerce or boards of trade which were not organized for profit.

The rationale for allowing an exemption for a not-for-profit commercial organization was that while the organization's purpose is commercial advancement, the benefits did not promote an advantage to one individual, but to the community as a whole.

The Revenue Act of 1938 expanded the earlier rationale:

> The exemption from taxation of money or property devoted to charitable and other purposes is based upon the theory that the government is compensated for the loss of revenue by its relief from financial burden which would otherwise have to be met by appropriations from public funds, and by the benefits resulting from the promotion of the general welfare.

The points made in this paragraph from the House Ways and Means Committee Report accompanying the Revenue Act of 1938 indicate a strong Congressional desire to exempt from taxation organizations which promoted benefits for the public welfare. With the advent of the modern Internal Revenue Code, Congress expanded these benefits to organizations that promoted the welfare of businesses and individuals.

The United Business Income Tax (UBIT) sections of the IRC were first added in 1950 and were substantially expanded in 1969. The basic intent in implementing the UBIT sections was to prevent unfair competition from occurring between for-profit and nonprofit businesses. Clearly the advantages of being designated as a tax-exempt organization were so great, it was necessary to ensure that organizations would not unscrupulously take advantage of their tax-exempt status.

Regulations section 1.513-1(b) of the IRC states:

> The primary objective of the adoption of the unrelated business income tax was to eliminate a source of unfair competition by placing the unrelated business income activities of certain exempt organizations upon the same tax basis as the nonexempt business endeavors with which they compete.

The regulations do not attempt to skirt the issue of defining a trade or business; in fact the regulations state specifically that for the purposes of section 513 of the IRC, the term " trade or business" carries the same meaning it has in section 162 of the IRC, and generally includes any activity carried on for the production of income from the sale of goods or performance of services. What has caused the definitional difficulties is the additional requirement that the income must derive from an activity which is not substantially related to the purposes for which the exemption is granted.

Obtaining a federal tax exemption is basic to the survival of the nonprofit entity, yet it is the least important benefit provided, at least in dollar terms. Once an organization is provided federal tax-exempt status, it then can qualify for exemptions under state and local law. These exemptions are not just from income tax, but also from sales and property taxes. In addition, exempt charitable and educational organizations are entitled to a reduced rate from the postal service on mailings.

Overview of the Nonprofit Sector

The definition of what type of activity is considered related or unrelated is the basis for much of the disagreement between the small business community and the nonprofit community. However, resolution of the problem requires an understanding of the issue beyond viewing the issue as a debate on relatedness. It requires the members of the Committee to understand what the nonprofit community has become.

At the present time, there are more than a million nonprofit organizations in the U.S. The modern nonprofit charitable organization is often a large, multi-million-dollar organization that is run as a business, using management techniques developed for large corporate organizations. Today's nonprofit organization can consist of a multi-tiered organization with a parent and several, sometimes dozens, of subsidiaries.

The National Geographic Society was the subject of an recent article in the Washington Post. The article detailed how the National Geographic has become, among other things, a major business conglomerate with reported revenues of $326 million in 1984. Remarkably it gave out a little more than $3 million in research grants in 1983.

The recent difficulties of the PTL organization are public knowledge. As their financial difficulties became evident, management sought out and hired the individual formerly responsible for managing Six Flags Over America, a major for-profit amusement facility.

While the original intent of the organizations, as stated in their charters and their applications for tax exemptions, remains basically intact, today's nonprofits are raising funds in ways unimagined just twenty short years ago.

For most charitable organizations, the basic fundraising methods of the past still hold true. They typically hold annual fundraising drives and annual sales events. However, more and more organizations are raising funds through business-related activities.

The best indicator of the changes in fundraising was detailed in a report prepared by the General Accounting Office (Feb. 1987). The study, entitled Competition

Between Taxable Business and Tax-Exempt Organizations, reveals several startling facts about nonprofit organizations. In particular, section 501(c)(3) organizations were supporting themselves at an increasing level with revenues raised by other means than by dues and contributions. In 1975, 39% of the funds raised by 501(c)(3) tax-exempt organizations were from business receipts. In 1982, 81% of the revenues from this same group came from other sources. For 501(c)(4) groups, 51% of the revenues were from program services.

Examples abound of the diverse ways in which nonprofit organizations are going about raising funds. The February, 1987 issue of Virginia Business detailed how the hospital industry in Virginia has prospered in recent years. The article mentions that the nonprofit Roanoke Memorial Hospital has established for-profit affiliates to operate two health clubs, an interior design firm, a pharmacy, and several other businesses.

In many communities, the local YMCA is going through a metamorphosis. Instead of providing facilities and programs for use by any member, including special subsidies for those who cannot afford membership, the new YMCA is becoming more like the health clubs seen in television commercials -- and they are not open to all

YMCA members. Use of these first class facilities requires a separate membership which costs more. The YMCA maintains that the fees are funnelled into programs which help their charitable functions succeed, but the amount of funds dedicated to charitable programs is disturbing.

The August, 1986 issue of Oregon Business ran an article entitled "What's Fair is Fair." In Multnomah, Oregon, the county tax assessor denied a property tax exemption to the YMCA under construction. The denial was based on the county assessor's determination that the YMCA was spending only 11% of its Multnomah County operating revenues on charitable purposes, and this level did not qualify the YMCA for the property tax exemption.

In the February, 1985 edition of Association Management, there was an article entitled "When Associations Become Entrepreneurs." The article describes a nonprofit organization which has developed a for-profit subsidiary to operate as a wholesaler for college bookstore members. It provides anything the college bookstores may want, including computers, software, student magazines, and cosmetics. This has turned into a $12 million business which has slowly resulted in many college bookstores competing with a growing list of off-campus facilities.

Other articles in various newspapers and magazines explore concerns that the move by nonprofit organizations into the for-profit sector is resulting in nonprofit hospitals losing sight of their responsibility to provide quality care for the indigent, run teaching programs, and otherwise take care of the community's health needs. In addition, there may be conflicts of interest between hospitals and doctors when the doctors have a financial interest in the success of the hospital. Often the hospital will exert formidable pressure on staff and affiliate doctors to refer patients only to subsidiaries of the hospital.

These examples are but a few of the hundreds which NFIB members have provided to us and which have been catalogued in their respective categories. Briefly, some of the other examples are:

Medical

- On-site hospital laundries soliciting business from the local community; pharmacies permitted to sell to anyone walking through the door; nonprofit hospitals exerting pressure on employees to ensure that sales and rentals of durable medical equipment to patients leaving the hospital are directed towards hospital-owned-and-operated subsidiaries; health clubs; commercial real estate ventures; community outreach centers operating as mini-clinics in competition with doctors and others involved in promoting local medical centers.

Hearing Aids

- While use of hearing aids has doubled nationally, dealers in St. Louis have not seen any increase in sales because 13 nonprofit hospitals have begun dispensing hearing aids during this period, and the hospitals' ability to restrict referrals limits sales for many small business owners who have been in the business for years.

Travel

- Travel agents are constantly forced to compete with university - subsidized travel packages and plans offered by tax-exempt organizations such as National Geographic and the American Association of Retired Persons (AARP). Incidentally, all of the mailings which include the solicitations are made using the subsidized postal rate of the organizations.

Museums

- At the Metropolitan Museum of Art in New York, visitors can buy calendars, desk diaries, stationary, post cards, and other gifts, which include reproductions of some of the museum's more popular works.

Churches

- In one community in a Midwestern state, the local church holds an annual event in which oriental rugs are brought in for a special sale. The rugs, which purportedly are being offered at reduced prices, are snatched up by patrons of the church who believe they are getting a bargain. No sales tax is collected, and neither the business nor the church pays income tax on the sales. The sales for this once-a-year event totalled nearly $350,000, which equals the annual gross sales of the average NFIB member. The mailings made to announce the event were made using the subsidy provided by the postal rates.

Schools

- Private colleges and state universities offer, through their alumni clubs, the opportunity for using a credit card. One percent of all sales made on these cards is funnelled back to the alumni fund. In addition the alumni fund receives a $25 finders fee for each member signed up. The solicitation is made at the reduced rate subsidy provided by the postal service to the university.

Labs

- A State-supported university allows its scientific departments to use their testing equipment to sell services as a testing lab to the private sector. They use university equipment paid for through grants and state and federal funds, and all the labor is performed by graduate students.

Humane Society

- In several states local Humane Society facilities have expanded beyond providing spaying and neutering facilities to poor families with pets. Once established in the community, they reach out to the general community and, regardless of income, offer for-fee services including grooming and elective medical procedures, in direct competition with veterinarians who must pay taxes.

Video

- A business which provides film and video tape services for local businesses for use in filming television commercials is competing with a television studio run by a local church for the same commercial business.

UBIT Statute -- Price Advantage and Market Entry

The UBIT statute and regulations allow the nonprofits to exploit the assets and activities of the nonprofit and, with imaginative planning, very little tax liability will result. This fact is best illustrated by the GAO study on nonprofits which revealed that while the nonprofit sector accounted for over $300 billion in economic activity, less than $100 million in tax revenues were paid. This gives this industry a federal tax rate of .03%.

The tax exemption leads to other advantages. It provides the tax-exempt organization with an advantage in pricing, allowing it to cut prices to enter into a market. A nonprofit organization can enter a market and stay there even at the risk of no profits or moderate losses because the usual economic rules do not apply. These situations can be very disruptive to local economies, especially in small towns, because the normal competitive pressures will not apply.

Borrowed Funds

The revenues from entrepreneurial activities are in part returned to the nonprofit parent, but in many cases the funds are reinvested in new business ventures. The ability to generate a nearly endless stream of tax-free capital, or to use the nonprofit parent's name and equity to borrow funds, or indeed for the parent to simply lend the funds at preferred rates, afford great advantages over small business competitors. One of the greatest problems for small firms over the last ten years has been the ability to raise capital, especially because of the risky nature of investing in any small business.

The nonprofit organization is prohibited from raising funds by issuing stock or by attracting outside investors. However, even here many nonprofits have managed to use imaginative techniques, and many are involved in the purchase of commercial and residential real estate which is portioned off and sold in limited partnership shares to outside investors. One such situation involves a hospital which has built a professional office building adjacent to the hospital and is selling interests to doctors and other medical professionals.

Asset Prices

A tax exemption provides a cushion for profits and allows a nonprofit, when bidding on land or other facilities, to outbid the for-profit business.

Postal Rate Subsidies

Certain organizations can take advantage of reduced postal rates on mailings to its members, and the reduced rates can be used to solicit funds, to attract new members, and to promote activities of the organization or benefits available to the members. The subsidy for nonprofits is in second and third class mailings, and it is generally available to 501(c)(3) entities, (c)(5) organizations, and organizations classified as religious, educational, scientific, philanthropic, agricultural, labor, veterans, or fraternal.

In many cases the postal subsidies are used to solicit a member's purchase of insurance, travel bargains, credit cards, and a whole range of membership benefits.

State and Local Property Tax Exemptions

An organization which is deemed charitable and therefore tax-exempt under section 501(c)(3) is eligible to receive exemptions from state and local property taxes. The rules may vary in each state, but essentially the organization must first obtain the federal exemption as a charitable group. Once received, this opens up all other necessary doors for tax exemption.

State Sales Tax Exemptions

Many states exempt nonprofits from payment of sales tax. If they are performing services on a regular basis, charitable organizations can often qualify under state law for an exemption from collecting sales taxes. If the charitable or educational organization promotes an annual event, it can usually obtain an exemption from collecting sales tax at these events as well. The rules vary from state to state.

Halo Effect

Possibly the least tangible benefit that a tax-exempt nonprofit can point to, but a benefit that may be its most important stock in trade, is what can be called the "halo effect," i.e. the belief and trust of the public that a nonprofit charitable organization is operating on behalf of the public welfare and that its efforts are not tainted by the need to make a profit.

This aspect is possibly the most difficult to deal with because it deals with the public's perception of an organization. The halo effect means that these organizations have, either by their deeds or people's perceptions, incurred a substantial amount of goodwill within the general public -- including many local community leaders and many owners of small businesses.

Trading on goodwill is certainly not illegal, but when a nonprofit organization trades on its reputation in the area of health care to begin selling memberships in health clubs, one has to begin to wonder if a line has not been crossed.

Recently an article in the Harvard Business Review created a firestorm of controversy. The article was entitled "Who Profits from Non-profits?" and was written by Professors Regina E. Herzlinger and William S. Krasker. The article concludes, among other points: "non-profit hospital chains receive more social subsidies than for-profits. They do not achieve better social results." Just possibly in the hospital industry, the halos are being worn by the for-profit hospitals, too. Certainly the findings of these two researchers would seem to indicate that there may be some doubt in the minds of some individuals.

Labor Market Advantages

Many nonprofits are able to attract individuals interested in working for low wages or even as volunteers, thus dramatically lowering labor costs and providing a substantial cost advantage between the nonprofit and the typically labor-intensive small business competitor, who must pay competitive wages and fringe benefits.

Common Threads of the Different Examples of Subsidized Competition Provided by NFIB Members

To help the members of the Committee arrive at their own conclusions on whether these situations may be nothing more than anecdotal or are indicative of a failure in tax policy, it is useful to analyze the common threads in all of the examples and illustrations.

Failure of UBIT Statute

In most of the letters received on the subject of nonprofit competition, one point is evident: the failure of the tax statute to provide clear guidance in defining related and unrelated activities for purposes of determining when income should be taxed or not taxed. The fact that the courts have so broadly interpreted the concept of the relatedness test is also frustrating and leads many small business advocates to believe that the current framework cannot be fixed to provide the necessary guidance.

It is unclear to us, as I am sure it must be unclear to you, what limits apply to a nonprofit organization in promoting an activity which in any manner furthers the organization's tax-exempt purpose. This lack of clarity translates into granting nonprofit organizations virtually limitless access to our markets and economy, without the discipline the free market rules of our economy impose on the rest of us. Perhaps the following hypothetical situation will help clarify the point.

Students Against Drunk Driving is an organization established to educate students and parents about the dangers of driving under the influence of alcohol, and to educate the electorate to insist on stricter enforcement of drunk driving statutes and increased penalties for offenders.

Several years down the road, the organization decides to establish educational programs to tour the schools, free of charge. Then as the need for funds increases to maintain the services it is providing and as contributions level out, management decides to raise funds in a new way. They determine that they can provide driver training classes and driving schools to certify driver education programs to the states. What chance are private driving schools going to have to compete against them? Under the UBIT statute, this activity would probably not be considered unrelated to SADD's original purpose. Therefore the small firms in the driver training business would have to compete against a non-taxed competitor.

Several years later, with the success of this first program underway, SADD decides to become involved in sales of alcohol detectors for drivers, to measure their level of intoxication. Several years later SADD gets involved in safety designs of cars to protect innocent victims from being hurt by a drunk driver.

This is a hypothetical situation, but based on what has happened with other nonprofits, it is totally plausible. The question to be asked is, is it desirable as a matter of fiscal policy as well as social policy? The small business owners who have been put out of business by the organization would ask Congress, and Congress has to ask itself the same question: when did this organization stop being a nonprofit organization and become a business?

The common perception of a nonprofit charitable organization is one which raises funds from the public and reinvests those funds in community facilities designed to help those in need. Is there any requirement of how much must be reinvested in the community? The short answer is no. While there are ethical and theoretical guidelines on the benefits which may accrue to the management of a nonprofit and its employees, no minimum exists of how many cents on a dollar must be used for the organization's primary purposes.

In fact many organizations would be embarrassed to reveal what percentage of total revenues is returned to the community the nonprofit is supposedly serving. That is because the profits of the subsidiaries are in many cases being used to expand the entrepreneurial aspect of the nonprofits. Hospitals and universities are becoming conglomerates and holding companies for vast numbers of subsidiaries whose profits are partially returned to the parent, but in large measure are used to capitalize new ventures.

Last January the Small Business Administration's Office of Advocay sponsored a conference on the issue of nonprofits. Representatives of both sides of the issue were represented at these sessions. The UBIT discussion revolved around the need for new guidance, or a "bright line," to be used to determine relatedness or unrelatedness, as well as when an organization is no longer a nonprofit but a business. No conclusion was reached, but the discussions clearly revealed the frustration with the current tax code framework.

Captive Referrals

A common concern expressed in many of the letters dealt with the issue of captive referrals. This situation is most common in university and hospital situations. Clearly, the university or hospital has an interest in ensuring that when a related subsidiary can provide a service or piece of equipment, the physician refers them to the hospital's subsidiary.

There is a concern that this will lead not just to the demise of many small businesses offering similar services, but also that the potential conflict of interest will cloud the perspective of the physician.

Financing of Subsidiaries

Many of the related businesses or for-profit subsidiaries are capitalized with funds from the nonprofit parent. The funds were donated by an individual, who in turn deducted such amount on his or her tax return, and the money was non-taxable income to the nonprofit. Is it fair to allow tax-free funds to be used in financing many of these for-profit subsidiaries? Of additional concern is whether the nonprofit's eligibility for bank loans is enhanced by the assets of the nonprofit parent.

Cost Allocation Rules

The UBIT statutes typically allow the for-profit to exploit some of the costs of the nonprofit parent, resulting in the sharing of the costs of the administrative facilities. These allocations allow expenses, which ordinarily are incurred by the nonprofit parent but which would not result in any tax benefit, to be allocated to the for-profit subsidiary where they are deductible under the UBIT rules. The allocation rules need to be strengthened and clarified to prevent this unncecessary gamesmanship being played with the IRS audit process.

Postal Subsidies

Reduced postal subsidies allows the nonprofits to mail advertising and literature informing the membership of services available. The reduced rate subsidies are also used to inform the membership of bargain airfares, insurance discounts, and other benefits arranged for the members.

Providing Services or Products to the General Public

In many cases the for-profit subsidiary and the nonprofit parent are marketing services to the general public, not just to the indigent.

IRS Enforcement

The issue of IRS enforcement was not mentioned earlier because directing the IRS to devote more resources to audits will not solve the problem. Certainly, better enforcement is necessary. The audit rate of nonprofits is embarrassing, and the results of the audits leave many questions unanswered.

It is our strong belief that the basic UBIT statute and the regulations need to be revised. The UBIT statute is too vague and leaves too many opportunities for interpretation to be considered effective in solving the problems of subsidized competition. The UBIT statute was intended to provide an enforcement mechanism, but as we have discussed, the rules for determining related and unrelated activities are unclear, the allocation rules provide more benefits than enforcement, and the enforcement is inadequate.

Suggestions for Action

The issue of unfair competition with nonprofits is both disturbing and complex. We have attempted to provide the Committee with examples of the increasing level of commercial activity occurring within the nonprofit sector, and we have outlined the various tax and non-tax benefits afforded the nonprofits -- benefits which are not given to their small business rivals in the commercial marketplace. Yet many of these same small business owners are active supporters of the primary activities of the nonprofit organizations.

Nevertheless, the phenomenal growth within the nonprofit sector and the rapid escalation of commercial ventures to raise revenues compel us to suggest to the Committee several options to begin promoting increased accountability by the nonprofits for their activities.

Central to increased accountability is a carefully-crafted revision of the UBIT statute and IRS Sections 501 and 511-514. While local jurisdictions have made some headway in tackling the issue, leaving resolution of the problems entirely to state and local action would be a mistake, resulting in a patchwork quilt of laws and rules which would do little to clarify an already-confusing situation. As nothing can begin until the federal tax exemption is granted, revision of the federal statutes is a necessary step.

The current "substantially-related" test and its broad judicial interpretations are in large measure responsible for much of the uncertainty which exists in the nonprofit statutes and have resulted in the large number of commercial activities of nonprofits. Imposition of a modified substantially-related test, a directly-related test, or a straight, stand alone income-producing standard each has a distinct advantage in solving the problem.

Whatever standard is eventually adopted for determining whether a nonprofit subsidiary should be taxed as a commercial venture, the standard should:

1. contain a clear test to determine when a commercial activity is taxable under the UBIT statute;
2. be sufficiently flexible to take into account transactions and situations which will certainly evolve in the future.

The current statutory standard used as the basis for determining whether an activity meets the substantially-related test does not require that the activities of the nonprofit parent be analyzed in an aggregate manner so that a determination of relatedness can be made based on all activities of the parent.

A substantial part of the problem will remain unresolved if nonprofit organizations can simply make a slight adjustment to their current methods of operations to once again come under the mantle of a nonprofit organization for all of their commercial activities. Past Congressional attempts to limit the commercial ventures of tax-exempt organizations failed; Congress attempted to impose clearer definitions, and the nonprofit community used these new definitions to become even bolder in their ventures.

Over the last twenty years, the nonprofit community has illustrated how successful it has become at operating commercial ventures. We believe that in the absence of a tighter, more effective standard of commerciality, the nonprofit community will simply adjust its commercial operations to non-taxable, nonprofit activities. Therefore, we strongly urge the subcommittee to be very clear in its definition of a commercial test in nonprofit operations.

Forty years of judicial test cases have proved that the substantially-related test does not work. To allow it to remain as the final standard, or to replace it with a standard just as weak, would not be an appropriate and effective answer.

Nonprofit organizations have been allowed the benefit of the doubt by the tax code and the courts. Their activities have been judged to be substantially related and non-taxable unless the nonprofit volunteers to pay taxes on some of its earnings. Even if it volunteers some part of its revenues as taxable, the UBIT statute allows the nonprofit other substantial advantages, so that its ultimate taxable income is not consequential.

Captive Referrals

From the outset, we have stated that it is not the threat of competition which concerns small business owners: competition is a fact of everyday life. Our concern is unfair competition arising from the special privileges and unique status nonprofits enjoy.

While taxes are one issue of concern, captive referrals and predatory marketing techniques are also serious considerations. For example, many nonprofit hospitals establish for-profit subsidiaries to sell or rent various services or pieces of equipment to the community. The great need for funds by nonprofit hospitals has led them to venture into the business community as competitors.

They begin their business by signing notes backed by the full faith of the nonprofit parent, providing them with substantial access to funds. Subsequently the hospital staff is instructed or requested to refer all patients to these subsidiaries, ignoring any suppliers in the private sector.

An entrepreneur decides to begin a business venture only after having done some preliminary marketing analysis to determine that a market for the product or service exists and to review the current competition. It is not necessary for the nonprofit parent to do the same kind of analysis; the nonprofit can in effect create the demand for the product or service by diverting all referrals to its subsidiary.

When a small business owner goes to a bank to borrow money for a business venture, market and competition factors are key to determining the credit worthiness of the business. However, when a nonprofit parent of some size guarantees the notes, business considerations are set aside.

An NFIB member provided a recent example of an unfair situation with local nonprofit hospitals. This member maintains a health and fitness center with the most up-to-date equipment and monitoring facilities. Recently three local nonprofit hospitals established wellness centers. These centers were originally designed to serve patients with cardiovascular problems. However, these facilities now have grown into complete fitness centers providing the same type of exercise equipment as the local small business. Additionally, they are selling general memberships at prices our member cannot possibly match, much less better.

Subsidiaries and Joint Ventures

Many nonprofit organizations use their financial base, strength, and community standing to establish subsidiary firms through which they funnel business. The nonprofit will then try to influence its professional affiliates to use the subsidiary.

A standard must be devised under which new subsidiaries must be capitalized, financed, and operated at arms' length, as third-party organizations. Once again, however, the standard must be such that the nonprofit organizations cannot simply evade their responsibility by shifting ownership among friends.

As in closely-held family businesses, attribution ownership rules must apply in a manner which prevents subterfuge by the owners to attain tax benefits they would not otherwise be entitled to.

IRS Administration

Without some kind of reporting requirements which require disclosure of the financial details of each subsidiary, IRS or any other agency will not be able to enforce standards. Currently no such requirement exists, and the nonprofit is only responsible insofar as it has any financial accountability. Even a certified audit is no guarantee that the UBIT standards are being met: the auditor will interpret the standard to meet the best interests of the client, not the IRS.

Many state legislatures are becoming increasingly interested in the activities of nonprofit organizations. However, their resources are even more severely limited than those of the IRS. The members of the subcommittee should understand that whatever decisions they make will affect the states' ability to tax as well. Most states have left the administration of the UBIT to the IRS under the mistaken impression that the IRS was keeping a close watch on nonprofit activities.

For any reform to be successful, the IRS must be in a position to know which entities are related to a nonprofit. Expanded reporting rules are necessary to require that a nonprofit identify those organizations in which it has an interest. The owner of a small business must identify any organization in which it has a 50% or greater interest; these rules should also be applied to nonprofits.

Allocation Rules--Passive vs. Active Income

One of the Ways and Means discussion options would require segregation of profit-making activities, similar to the passive loss rules enacted under tax reform. This rule would prevent one loss subsidiary from offsetting losses against a profitable one. Essentially, this recommendation would instill some economic concerns in the management of the nonprofit parent. This option is one which should be given serious consideration.

GOVERNMENT COMPETITION

The Executive branch has modified by gradual stages over the years its policy of absolute reliance on the private, for-profit sector for goods and services required by the Federal government, ultimately reaching the point where, in 1979, the revision of the Office of Management and Budget (OMB) Circular A-76 -- the centerpiece of procurement policy -- included language that clearly gave precedence to cost-effectiveness over reliance on the private sector, and, further, negated any distinction between private, for-profit businesses and nonprofit entities in terms of preference in awarding Federal contracts.

Despite these changes, the essential policy remains that the government should not compete with its citizens. Nevertheless, government does compete with the private sector, and on a vast scale. The General Accounting Office (GAO) indicates that an estimated 400,000 Federal employees are currently operating over 11,000 commercial or industrial activities at an estimated cost approaching $19 billion annually. In other words, nearly one of every four employees of the Executive Branch civilian work force is currently engaged in activities which are clearly not of a policy, decision making, or managerial nature, in direct competition with employees performing essentially the same activities in the private, for-profit sector. Yet a significant proportion of these activities cannot even be justified on a cost savings basis, in accordance with the dictates of Circular A-76. The GAO study points out that cost comparisons recently completed by the Department of Defense (DOD) "show that more than half of its commercial activities could be obtained more economically by contract."

The amount of direct government competition with private enterprise is obviously extensive in terms of the cost, and is equally extensive in terms of the variety of goods and services involved. While the GAO study mentions a few of these activities, the best source work currently available on the subject is the report published in March, 1980, by the Task Group on Government Competition with Small Business, under the auspices of the Small Business Administration's Office of Chief Counsel for Advocacy. Comprised of eighteen small business owners, several of whom had experience with direct or indirect competition from government entities at the federal, state or local level, the Task Force amassed a wealth of information from government officials, small business owners, and trade association representatives, and documented numerous specific instances of direct Federal Government competition with small firms. Examples include activities in areas such as audio-visual products and services, automatic data processing, printing and reproduction, basic business services, manufacturing, systems engineering, maintenance, real property, research and development, industrial shops and services, transportation an miscellaneous services. This list only partially covers the range of commercial/ industrial activities performed by government employees -- all of which are readily available in the private, for-profit sector. Other activities come readily to mind, such as government owned-and-operated campgrounds, military post exchanges, and the relatively recent innovation of the House of Representatives liquor service.

Reliance on the private sector for goods and services needed by the government makes good sense, philosophically and economically. Government competition with private enterprise promotes serious concern about the proper function of government in a free enterprise economy. Over the past twenty years, GAO has issued numerous reports on the contracting process, and repeatedly has drawn a marked distinction between the proper role of the government employee (basic management function) and the private sector (commercial/industrial function). NFIB wholeheartedly agrees. In-house production of goods and services translates into lost income for small businesses. Lost income means lost tax revenues, from both the business itself and from the employees the business would have hired to perform the additional work that a Federal contract would bring. Further, reliance on the private sector would result in significant cost savings to the Federal government.

The inescapable conclusion is that the private sector is significantly more efficient in delivering needed goods and services than is the public sector. As one economist stated, such findings lead to the suggestion of a "Bureaucratic Rule of Two: Removal of an activity from the private to the public sector will double its unit cost of production."

A strong commitment to private sector reliance for the provision of needed goods and services is essential. Therefore NFIB wholeheartedly supports efforts to clarify and reaffirm, by legislative mandate, this basic policy of reliance on the competitive private enterprise system.

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Testimony of the National Assembly
and
The Grants and Contracts Project

Small Business Committee
U.S. House of Representatives
June 29, 1988

I. Introduction

Good morning. My name is Geneva Johnson and I am President and Chief Executive Officer of Family Service America. With me is Janne Gallagher, counsel to the Grants and Contracts Project and co-author, with Harrison Wellford, of the forthcoming National Assembly book, Unfair Competition? The Challenge to Charitable Tax Exemption.

The National Assembly is an association of national voluntary human service organizations whose members collectively serve over 50 million people each year. The Grants and Contracts Project, which exists to improve governmental administration of grants and contracts with nonprofit health and human service agencies, is made up of fifteen national voluntary human service organizations. A membership list for both organizations is attached.

Before turning to the main focus of my testimony, I would like to dwell a moment on two very important points.

AFL-CIO, Department of
Community Services
American Association of Homes
for the Aging
American Camping Association
American Red Cross
The Association of Junior Leagues
Big Brothers/Big Sisters of America
Boy Scouts of America
Boys Clubs of America
Camp Fire
Catholic Charities USA
Child Welfare League of America
Council of Jewish Federations
Evangelical Lutheran Church in
America
Division of Mission and Ministry
Family Service America
4-H
Future Homemakers of America
Girl Scouts of the U.S.A.
Girls Clubs of America
Goodwill Industries of America
National Council of Negro Women
National Mental Health Association
The National Council on the Aging
The National Crime Prevention
Council
The National Network of Runaway
and Youth Services
The Salvation Army
Travelers Aid Association
of America
Travelers Aid International
United Neighborhood Centers
of America
United Seamen's Service
USO (United Service Organizations)
United Way of America
VOLUNTEER-The National Center
Volunteers of America
YMCA of the USA
YWCA of the U.S.A., National Board

First, nonprofit human service organizations depend on the generosity of many small business executives who serve as board members and contribute their time, their ideas, their energy and their money to supporting charitable activities in their communities. Second, through services provided to the whole community, rich and poor, charities make communities a better place to live and work, where businesses are able to recruit and maintain a productive workforce and operate in a safer and more congenial environment.

A year ago, Frank Swain told the Ways and Means Oversight Subcommittee that "the relationship between many nonprofits and for-profits is very close." We agree with this judgment. Human service nonprofits have taken a number of steps to try to preserve that close relationship in the face of the competition debate, including holding meetings with small business representatives both in Washington and in local communities. We intend to continue that dialogue.

We have also taken steps to inform and educate human service organizations about their duty to comply with the unrelated business income tax. One important step in this direction was the preparation and circulation of a manual on compliance with UBIT. National organizations are encouraging their local affiliates to review their conformance with the law.

Human service organizations also have supported several of the changes to the federal tax code suggested for discussion by the Ways and Means Oversight Subcommittee. While we still have some differences of opinion with the subcommittee on the proposals, we do support:

- Retention of the substantially related test;
- Expanding tax information reporting to require nonprofits to supply more detail on revenue producing activities and income;
- Increasing the UBIT deduction (and the threshhold for filing) with a phaseout beyound $50,000;
- Applying UBIT to certain health and fitness activities unless the program is available to a reasonable cross-section of the general public;
- Taxing royalties that are measured by net or taxable income;
- Modifying the definition of a controlled subsidiary; and
- More vigorous enforcement of the substantially-related test.

For human service organizations, federal and state income tax exemption and exemption from state and local property and sales taxes are by far the most important of the benefits conferred on nonprofit organizations. Consequently, this morning we will provide the committee with information about human service nonprofits, what they do, how they are supported and why they are exempt from income and property taxation. Our testimony reflects the results of a study of these nonprofits, undertaken with assistance from the Rockefeller Brothers Foundation and the Ford Foundation, the results of which will be published next month in the book, Unfair Competition?.

The tradition of tax exemption for charitable activity is very strong in America. With its roots in Elizabethan England, the recognition that charitable activity both provides important public benefits and reduces the burdens of government crossed the Atlantic with the first British settlers. Property tax exemption for charitable and benevolent activities is guaranteed in virtually every state constitution and, in the few where it is not, is provided for in the state's laws. When the federal government adopted its first corporate income tax -- to support the Civil War -- an exemption was allowed for literary, scientific and charitable organizations. Similar provisions can be found in every federal income tax law enacted since that time.

America has long been a three-sector society: government, business and the third, or nonprofit, sector. This pluralistic tradition has been a source of creativity and freedom unknown in many other countries. Tax exemption not only encourages the provision of the services offered by the third sector, it also recognizes the need for that sector to remain free of central bureaucratic control.

II. Definition of human service agencies

Human service providers are those nonprofit organizations that assist the growth and development of individuals and families and help them address crises in their lives. They are citizen-led organizations such as the American Red Cross, Boys Clubs, Girls Clubs, the Salvation Army, Volunteers of America, Boy Scouts and Girl Scouts, Goodwill Industries, Family Service agencies, child welfare agencies, Catholic Charities, Jewish Federations, Lutheran Social Service agencies, YMCA's, YWCA's, United Ways and other similar organizations that provide services in every community across America.

Most human service nonprofits are local community organizations. They are governed by local volunteer boards of directors drawn from among the members of the community they serve. Nonprofit human service organizations depend on the support of community leaders, including small business executives. They depend on them as volunteers, they depend on their intelligent judgment for guidance in priority-setting, they depend on them for contributions and they depend on them as a source of goods and services that nonprofits must purchase in order to operate. Businesses, both large and small, also rely on human service nonprofits.

Human service agencies may help an employee with a drug problem; they may counsel a troubled family and reduce distraction and absenteeism of employees; they may give training to a disabled person and provide a business with a new and valuable employee.

III. Fee for service income

Many of the activities human service agencies regard as central to their missions are partly supported by fees charged those who are able to pay. Fee-for-service income is not a new source of revenue for human service nonprofits. The collection of fees has been an integral part of their operation for more than 100 years. Catholic Charities agencies have depended partially on fees since the eighteenth century. YMCAs have always relied on membership fees to support their organizations. Jane Addams' Hull House, established in 1889, opened a book bindery and other businesses to train unemployed members of its community in skilled crafts; they earned income to support the effort by selling the articles the trainees manufactured. The Salvation Army sometimes charges nominal fees for food it provides senior citizens.

The majority of agencies which charge fees do so on a sliding scale based on ability to pay. The poor pay little or nothing; the better-off pay proportionally higher fees. Others charge a flat fee, but provide scholarships or other means of financial assistance to those who cannot pay. Some agencies simply ask clients to pay what they can.

United Way of America, with the assistance of its local affiliates, recently surveyed a statistically representative sample of the 37,000 local agencies that receive United Way funding. The results showed that human service nonprofits continue to fulfill their historical mission of making services available to the entire community without regard to ability to pay. Of the 65% of the agencies that charged fees for services or products, 85% did so at less than cost or based on ability to pay. 36% of all products and services were offered free of charge. Because cost-reimbursements from third-parties, such as the government or private insurers, usually did not cover the full cost of providing the service, agencies subsidized the balance through charitable contributions or charges to those able to pay the full cost.

Paying a fee, when one can, lends dignity, self-respect and self-determination. It teaches young people responsibility. Some agencies believe that paying what one can is an essential part of the help being offered.

Charging fees also enables agencies to serve a broad cross-section of the community. Many who are not poor enough for government assistance are also not prosperous enough to afford the full cost. Nonprofits can provide the help they need.

Serving the whole community assures the poor that they are not being given second-class service. It avoids a two-tier system, one for the poor and one for the better-off. Finally, it often helps give better-off members of the community an awareness of community problems and attracts their interest as volunteers and their financial support as contributors.

IV. Common Misunderstandings About Nonprofit Human Service Organizations

Some small business advocates suggest that any income generating activity by a nonprofit should be taxed if a profit-making business offers a similar service. Underlying this suggestion are several persistent myths about nonprofit human service organizations.

Myth One -- The Golden Age

We have encountered a belief that there once was a golden age of charity when services were provided free of cost using funds acquired through contributions. In fact, however, human service charities always have relied on a combination of government funding, private contributions, membership dues and fees for services rendered. In response to cuts in government funding, some organizations have instituted or increased fees. Others have sought alternative sources of government support.

Nonprofit human service agencies, like nonprofit museums, hospitals and universities, serve more than just the poor. They serve many individuals who fall in the gray area between poverty and the ability to pay the full cost of a service. Nonprofits serve people in need: single parents, Vietnam veterans, people with AIDS, drug and alcohol abusers, all of whom may be in need of human services regardless of their income. Failing to charge something to those who can pay something would be an inefficient use of scarce resources. Neither the government nor nonprofits can afford to meet the many demands for social services free of charge.

Myth Two -- Charging Fees Is a New and Rapidly Growing Source of Revenue for Nonprofits

While fee income is growing for some human service nonprofits, it remains a relatively small proportion of total income for social service agencies as a group.

In 1984, the primary sources of support for nonprofit providers of social services were:

government grants and payments	43.9%
charitable contributions	37.4%
fees for service	12.6%

The foregoing figures substantially understate the amount of private charitable support given to social service agencies because they do not include the value of the services donated by volunteers. If it were possible to fully account for the value of volunteers' time, the private support received by social service agencies would far exceed any other revenue source. The Salvation Army alone, for example, was served by more than 950,000 volunteers in 1986: these volunteers contributed more than 11 million hours of service. Independent Sector estimates that volunteers permitted social services agencies to more than double their total expenditures in 1984. If the value of these services is added to charitable contributions, 63% of the total support for social service agencies in 1984 came from a combination of charitable contributions and volunteering.

The proportion of revenue coming from fees and dues has increased in recent years, but that increase has not been large and, contrary to popular opinion, has not been at the expense of private charitable support. In 1977, private payments accounted for 9.6% of funds raised by social service agencies. These payments were 12.6% of total funds raised in 1984, an increase of 3% in their share of total revenue, most of which took place between 1977 and 1982.

Aggregate figures do not, of course, provide a complete picture. The relative importance of fees and dues as a source of support varies by organization, by program and even by geographical location. Some human service nonprofits, such as the YMCA's, receive substantial support from fees and dues. But this is not a recent development -- the Y's mix of revenues is the same today as it was in 1950.

Myth Three -- Charities Are Aggressively Branching Out into the World of Business

For all but a tiny handful, this is not the case. The United Way of America survey confirmed that human service organizations to which United Ways distribute funds are not aggressively branching out into commercial enterprises. Only 7% of the organizations filed Form 990-T. Average gross unrelated income for those organizations was less than 3% of total agency revenue and only 3% of the organizations had established for-profit subsidiaries. Moreover, while the United Way survey did not establish the nature of the activity that led the organization to file a Form 990-T, an informal Grants and Contracts Project survey leads us to believe that the primary taxable activity is related to the ownership of debt-financed property, not the active conduct of a trade or business.

The survey also found no evidence of lack of compliance with current IRS filing requirements. Over the past five years, only 1% of the agencies reported that the IRS challenged the tax exempt status of an activity in the course of an audit. However, none of these activities was found to be taxable at the conclusion of the audit. In 75% of the cases, the activity was ultimately determined to be related; the rest were unrelated but otherwise exempt.

Myth Four -- Competition by Tax Exempt Organizations Is "Unfair"

There is no evidence that tax exemption allows nonprofits to compete "unfairly." The two advantages most frequently cited by small business advocates are that tax exemption permits nonprofits to charge lower prices and that tax exemption permits nonprofits to accumulate income free of tax for use in expanding their activities.

To the extent that costs, and therefore fees, are less because of tax exemption, tax exemption helps nonprofits carry out their mission. If a service, such as family counseling, costs less because of tax exemption, a greater number of people will be able to benefit from it. This benefit to the community must be weighed against the impact, if any, on for-profit firms' ability to attract additional customers.

Accumulation of surplus, tax free, also is not a form of unfair competition because the surplus, and any capital assets it is used to acquire, must be dedicated to a public purpose. Again, the primary question is not whether a nonprofit has a relative advantage vis a vis a business person, but whether the nonprofit is using the surplus to carry on an activity that the tax code seeks to encourage.

Myth Five -- There Is a Clear-cut Distinction between Commercial and Noncommercial Services

Certain small business advocates argue that nonprofit organizations can be neatly divided into those that are "commercial," i.e. those that rely on income from fees for services, and those that are "donative," i.e. those that rely on contributions and volunteer services. This dichotomy does not reflect the real world.

Human service nonprofits receive income from a variety of sources including donations, government grants, fees for services, membership dues and sales of goods. To call them "commercial" because part of their income is from services ignores what these organizations regard as the real distinction -- why the services are offered, to whom they are offered, and the value to the community in having broad access to them.

Nor would taxing "commercial" nonprofits necessarily alleviate the enforcement burdens faced by the IRS. If this test were adopted, either virtually all nonprofits would be subject to tax, or the IRS would have to undertake a tedious service-by-service, market-by-market comparison of nonprofit services with those of for-profit organizations to determine whether they are truly competitive and thus "commercial."

The most important reason not to adopt the test of commerciality, however, is that it turns on its head nearly four hundred years of common-law and legislative precedent. The test for tax exemption always has been whether the aims and goals of the charity provide a public benefit and whether the charity's assets are devoted to accomplising those goals.

V. Public Policy Supports Tax Exemption for Nonprofits

A fundamental rationale for tax exemption for nonprofits is that they provide a variety of goods and services that would not otherwise be supplied either in adequate quality or quantity. There are areas in which a purely market economy is deficient in supplying goods and services because it is impossible to charge those who benefit a price that equals their value, in this case because they benefit society as well as the individual. A teenager cured of drug addiction, for example, receives an immediate benefit, but the community as a whole also benefits. The same is true throughout the spectrum of nonprofit services from day care to nursing homes.

Government also refrains from taxing the income and property of nonprofit organizations to encourage the growth and development of voluntary associations among its citizens. Voluntary organizations offer an alternative to both the government and the private market that encourages trust among the recipients of its services. Because so many of the services are highly personal in nature, consumers may prefer a provider who is motivated primarily by generosity and altruism. Many people may prefer a specific religious and cultural setting: one family may choose day care at a Jewish Community Center, another may seek counseling under the auspices of Catholic Charities, a third may choose to join the YMCA because it has programs for all members of the family and offers goals beyond simple physical fitness. An alcoholic may seek assistance from an organization staffed with fellow alcoholics who instinctively understand and sympathize with the problem. Tax exemption helps keep these choices available to all.

Nonprofit organizations also engender trust because of the standards they enforce. In many cases, standards first internally adopted by nonprofit service providers have become the norm for the community as a whole. The Council on Accreditation, an independent body organized by human service nonprofits, requires periodic accreditation of its members to assure they are maintaining professional standards.

Nonprofits strengthen their communities by providing a mechanism through which local people can solve local problems through voluntary action. Nonprofit human service organizations are governed by community-based boards of neighbors. Local control allows for greater flexibility and responsiveness in meeting community needs.

Nonprofits have a commitment to their communities to provide services in good times and bad, whether they are profitable or not. Nonprofits are less likely to drop an individual whose resources or government benefits have been exhausted. The track record of many human service nonprofits underscores their role as reliable providers of human services. Tax exemption helps ensure that communities will not be deprived of vital services if the vagaries of the market or shifts in government policy reduce or eliminate the ability to make a profit.

Nonprofits have been a fertile source of creative solutions to community problems. Because their motivation is contributing to the public good, and not a healthy balance sheet for the next quarter, they have greater flexibility to experiment with new programs and approaches to relieving social problems. Meals on Wheels, treatment for alcoholics and drug abusers, workshops for the blind and severely handicapped, community blood banks, visiting nurses, even basketball and volleyball -- the human service landscape is fertile with the innovation of nonprofits, many of which have subsequently been adopted by government and for-profit corporations. Tax exemption helps assure that nonprofits will be able to continue this tradition of creative problem-solving. It also helps guarantee that the nonprofits which form a valuable part of the infrastructure of our nation's communities will continue to exist from generation to generation.

Tax exemption has been a spring-board for mobilizing the donations and volunteer services that make services available with far less government support than would otherwise be required. The Salvation Army, for example, spends more than the entire federal government on alcohol and drug abuse treatment. Nonprofits spend $1 billion more a year on rehabilitation services than federal and state governments combined. The millions of hours of volunteer services provided free of charge are an important community resource. If nonprofits did not offer these services, either the government would have to pay for them or people would go without help they need.

Nonprofits also have been schools for citizenship and nurseries for leadership. Many volunteers, who got their first taste of community service through hours devoted to a local charity's board of directors, go on to community service as a whole. Nonprofits help build bridges between generations and classes within a community, fostering a community tolerance and unity.

* * *

Various tax policies, both federal and state, appropriately support both nonprofits and small businesses. We do not believe that the solution to the problems that have arisen lies in adjustments to the tax code or the imposition of bureaucratic procedures on small nonprofit organizations. Rather, we believe that the solution lies in small businesses and nonprofits working together at the local level to identify problem areas and to try to find ways in which both can continue to offer vital services to their communities.

MEMBERS OF THE NATIONAL ASSEMBLY
1988

AFL-CIO, Department of Community Services
American Association of Homes for the Aging
American Camping Association
American Red Cross
The Association of Junior Leagues
Big Brothers/Big Sisters of America
Boy Scouts of America
Boys Clubs of America
Camp Fire
Catholic Charities USA
Child Welfare League of America
Council of Jewish Federations
Evangelical Lutheran Church in America
   Division of Mission and Ministry
Family Service America
Future Homemakers of America
Girl Scouts of the U.S.A.
Girls Clubs of America
Goodwill Industries of America
National Council of Negro Women
National Mental Health Association
The National Council on the Aging
The National Crime Prevention Council
The National Network of Runaway and Youth Services
The Salvation Army
Travelers Aid Association of America
Travelers Aid International
United Neighborhood Center of America
United Seamen's Service
USO (United Service Organizations)
United Way of America
VOLUNTEER - The National Center
Volunteers of America.
YMCA of the USA
YWCA of the U.S.A., National Board

MEMBERS OF THE GRANTS AND CONTRACTS PROJECT 1988

American Red Cross
Boys Clubs of America
Boy Scouts of America
Catholic Charities USA
Child Welfare League of America
Council of Jewish Federations, Inc.
Family Service America
Girl Scouts of the U.S.A.
Goodwill Industries of America, Inc.
Lutheran Social Services System
The Salvation Army
United Way of America
Volunteers of America
YMCA of the U.S.A.
YWCA of the U.S.A., National Board.

Statement of the U.S. Chamber of Commerce

ON: NONPROFIT COMPETITION WITH BUSINESS

TO: HOUSE COMMITTEE ON SMALL BUSINESS

BY: DR. EARL H. HESS

DATE: JUNE 29, 1988

The Chamber's mission is to advance human progress through an economic, political and social system based on individual freedom, incentive, initiative, opportunity and responsibility.

The U.S. Chamber of Commerce is the world's largest federation of business companies and associations and is the principal spokesman for the American business community. It represents nearly 180,000 businesses and organizations, such as local/state chambers of commerce and trade/professional associations.

More than 92 percent of the Chamber's members are small business firms with fewer than 100 employees, 59 percent with fewer than 10 employees. Yet, virtually all of the nation's largest companies are also active members. We are particularly cognizant of the problems of smaller businesses, as well as issues facing the business community at large.

Besides representing a cross section of the American business community in terms of number of employees, the Chamber represents a wide management spectrum by type of business and location. Each major classification of American business--manufacturing, retailing, services, construction, wholesaling, and finance--numbers more than 10,000 members. Yet no one group constitutes as much as 31 percent of the total membership. Further, the Chamber has substantial membership in all 50 states.

The Chamber's international reach is substantial as well. It believes that global interdependence provides an opportunity, not a threat. In addition to the 56 American Chambers of Commerce Abroad, an increasing number of members are engaged in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

Positions on national issues are developed by a cross section of its members serving on committees, subcommittees and task forces. Currently, some 1,800 business people participate in this process.

STATEMENT
on
NONPROFIT COMPETITION WITH BUSINESS
before the
HOUSE COMMITTEE ON SMALL BUSINESS
for the
U.S. CHAMBER OF COMMERCE
by
Dr. Earl H. Hess
June 29, 1988

I am Earl H. Hess, President of Lancaster Laboratories, headquartered in Lancaster, Pennsylvania. I started my company in 1961, with my wife and one laboratory technician, as what you might call a scientist in private practice. I can tell you, first hand, of horror stories surrounding the start up years, made even more difficult because of unanticipated university competition. Nevertheless, we did survive and have, in recent years, been growing rapidly in spite of continuing competition from nonprofits, partly, I believe, because of the quality of service that we offer and partly because we are serving a rapidly expanding market. I have been working for nearly 20 years to bring public attention to the issue of nonprofit competition and sincerely appreciate the opportunity to appear before you today. I commend you for directing your attention to this issue which is crucial for so many small businesses.

Today, I am representing the U.S. Chamber of Commerce. I am a member of its Board of Directors and also serve as Chairman of the Legislative Policy Committee of its Small Business Council. Accompanying me today from the Chamber are Christine Russell, Director of the Small Business Center, and Nancy Fulco, Associate Manager for Legislation for the Small Business Center. I also serve as a board member of the Pennsylvania Chamber, chaired the Lancaster Chamber in 1985, served as president of my national trade association, the American Council of Independent Laboratories, from 1984 to 1986, and chaired the Pennsylvania Delegation to the White House Conference on Small Business in 1986.

Lest you think that my nonprofit associations are limited to trade associations, that include small business advocates, I can further identify my association, present and past, with a variety of religious, educational and charitable nonprofits, including board positions on a seminary and a nonprofit retirement home and volunteer leadership of my local congregation.

By giving this extensive personal background, I wish to convey the fact that I do not oppose nonprofits per se; quite to the contrary, I believe that the volunteer sector is vital to the welfare of our society and in most cases complements beautifully the free enterprise system by minimizing the size and cost of government. That is exactly the conclusion of the Chamber, after careful study of this issue since the 1986 White House Conference and after review of the voluminous materials generated as a result of the House Committee on Ways and Means' Subcommittee on Oversight hearings.

The Chamber opposes the unfair competition engaged in by some tax-exempt organizations, while recognizing the legitimate and important role played by most tax-exempt organizations. The Chamber has long-standing policy that each type of lawful enterprise "should stand on its own merits with protection from unfair competition."

The Chamber itself is a nonprofit organization operating under Section 501(c)(6) of the Internal Revenue Code. It is composed of approximately 180,000 members -- large and small businesses, trade and professional associations and chambers of commerce. Approximately 92 percent of the Chamber's members are small, independent businesses with fewer than 100 employees. These businesses are the driving force not only for the U.S. economy but also for such business organizations as the Chamber and most of the 4,000 nonprofit business organizations that make up the U.S. Chamber of Commerce Federation.

The Chamber, as a representative of the business community, has no interest in shielding any of its members, large, small or nonprofit, from competition. The Chamber supports full and open competition, with limited government involvement in setting the basic rules, allowing private enterprise and individual initiative to solve most of society's problems and providing the goods and services that the consumer wants.

With that said, however, the Chamber believes that unfair competition from nonprofits is a significant and growing problem that most injures those businesses that are the most vulnerable -- the small ones. Although it is readily apparent that only a small number of tax-exempt organizations abuse their status, the small business community, through the White House Conference, the Ways and Means Oversight hearings and other forums, has made its case that the issue is one that needs to be addressed. The Chamber commends this Committee for allocating resources to "sort out" this difficult problem.

My experiences have convinced me that this problem can be alleviated without significant injury to the important function of tax-exempt organizations.

The Chamber believes that, over the past 40 years, federal laws have introduced various tax exemptions and subsidies that have had the unintended consequence of encouraging new groups of 501(c)(3) organizations to be formed and some existing 501(c)(3) organizations to expand and diversify into nontraditional enterprises for the primary purpose of earning tax-exempt income to support their other activities.

Accordingly, the Chamber supports revisions in the definitions and application of the Unrelated Business Income Tax (UBIT) to ensure that activities of otherwise tax-exempt organizations do not compete unfairly with existing for-profit enterprises. This should be done, while at the same time maintaining a vibrant, tax-exempt, nonprofit sector, which is critical to the maintenance of a sound social fabric.

I. Profile of Tax-Exempt Organization Activities

A. Introduction

The macroeconomic statistics of tax-exempt organizations make a compelling case for this Committee to address this issue. Tax-exempt organizations are a large and rapidly growing sector of the economy.

The U.S. has a history of encouraging philanthropy and voluntary initiative to aid people to perform activities that businesses either cannot or will not do directly. Certainly, this tradition has motivated much of the growth in the nonprofit sector since the 1940s.

It is a law of economics that to encourage behavior you provide incentives for it and to discourage behavior you provide disincentives for it. Since the 1950s and earlier, national policy in the U.S. has provided incentives for nonprofits, particularly 501(c)(3) organizations. This has encouraged formation of new nonprofit organizations and fueled the growth and diversification of existing organizations, particularly in the education, health care and research sectors. On the whole, this has been good for our society, but it has led some 501(c)(3) organizations into commercial activities.

An example of incentives provided by the government for 501(c)(3)s involves payroll taxes. Certain nonprofit organizations can elect to exclude themselves from some payroll taxes. However, since the 1950s, taxes on business, particularly payroll taxes, have increased, thus giving these nonprofit organizations a competitive advantage with businesses -- particularly in the areas of education, health care and research. This Committee is well aware of the concerns of small business with payroll costs. This exemption has been a major factor in bringing the problem of unfair competition to a head, as taxpaying businesses and tax-exempt organizations increasingly compete to provide technical and recreational services demanded by customers in our changing economy. Exemption from income tax, sales tax and property tax, along with the availability of special mailing rates, all combine to provide the 501(c)(3) with a tremendous economic advantage in competing with a small business in the commercial workplace.

B. Rapid Growth of the Tax-Exempt Community

A 1987 General Accounting Office (GAO) study describes in detail the growth of the tax-exempt sector and the spread of some nonprofits into commercial activities.[1]

> The tax-exempt or nonprofit community has increased over the years in terms of number of organizations, statutory tax-exempt categories, types of activities, and resources. It now represents a diverse set of organizations ranging from rather informal social or neighborhood clubs with limited resources, to complex multimillion dollar medical complexes, educational institutions, and fund-raising organizations. . . .
>
> The number of statutory tax-exempt categories has also continued to increase, growing from 15 in 1946 to 25 in 1986. As the number of categories has increased, so has the number of specific exempt activities within these categories. The IRS [Internal Revenue Service] listed 90 different tax-exempt activities in 1965, but now there are over 260 such activities. Further, many tax-exempt organizations engage in more than one activity. . . . While many of these appear to be traditional charitable-type activities, such as missionary and fund-raising activities, others appear to be more similar to taxable businesses in nature. (1987 GAO study, p. 14.)

"The tax-exempt community has sizeable financial resources and continues to increase as a share of the national economy," up from 1.3 percent of Gross National Product (GNP) in 1930 to 3.3 percent or $131 billion in 1985, according to a U.S. Department of Commerce estimate. (1987 GAO study, p. 15.) Other estimates have placed the tax-exempt sector's share of GNP as high as 9.0 percent or $300 billion.

The GAO study also indicates that the tax-exempt community is dominated by 501(c)(3) organizations -- educational, health, charitable and religious.

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[1] "Competition Between Taxable Businesses and Tax-Exempt Organizations," February, 1987, Briefing Report to the Joint Committee on Taxation, U.S. Congress, General Accounting Office (hereafter, "1987 GAO study").

Within this category, educational and health organizations are the largest and the most rapidly growing, representing 53 percent of 501(c)(3)s' revenues in 1975.

Although there are many small, community-based nonprofit organizations, the tax-exempt community is, in reality, highly concentrated and is dominated by a small number of large organizations that control the majority of total tax-exempt community resources. Whereas only one percent of all tax-exempt organizations filing reports with the IRS had an annual revenue of $10 million or more in 1975, this small group accounted for $68.9 billion or 60 percent of the tax-exempt community's total revenue that year. Again, health and educational organizations dominated this group.

It should come as no surprise that health and educational organizations dominate the tax-exempt sector. They perform extremely important, costly and complex services, and they receive the most generous subsidies and tax exemptions. All income from research done for the government or done by colleges and universities for other groups is tax-exempt income under current federal law. Similarly, tax-exempt hospitals and related health care institutions receive generous exemptions and subsidies under federal law. These are irresistible incentives for many universities, hospitals and other exempt organizations, particularly those experiencing financial difficulty, to expand their research activities into commercial areas.

In addition to this growth, entry into nontraditional businesses and concentration of resources in health care and educational fields, one more point needs to be made about the tax-exempt sector: it is becoming increasingly reliant on income-producing or commercial activity. The 1987 GAO study found that revenues from sales of goods and services represented 75 percent of the income of tax-exempt organizations in 1978, up from 57 percent in 1946.

We should not conclude from this profile that tax-exempt organizations need to be regulated strictly or dissolved or that the concentration of their resources in a small group of organizations is harmful. The biggest nonprofit organizations are some of the best-known and important institutions in our society: the Memorial Sloan-Kettering Cancer Center, United Way, the state university system, and the Smithsonian Institution.

However, we must recognize that these and other important and respected institutions must regulate their own expanding activities carefully and must concentrate on their missions rather than on their ability to sell commercial goods and services.

II. The Response to Competition by Tax-Exempt Organizations with Business

A. General Response

An increasing number of business organizations, including the Chamber, believe that this is a serious and growing problem deserving review and redress by policymakers.

The Chamber is a member of the Business Coalition for Fair Competition (BCFC), a group of approximately 30 trade associations whose members have been and are experiencing unfair nonprofit competition.

BCFC, other business organizations and individual businesses already have or will be providing specific examples during these hearings of the types of competition that they are facing. However, I do want to summarize the reactions of small businesses to the problems posed by nonprofit competition.

The 1987 GAO study surveyed 1,700 businesses in six industries -- independent research, racquet sports, veterinary services, travel, tour and audio-visual communications -- and found that nonprofit competition is a significant problem for each industry. Eighty-four percent of the research businesses, 90 percent of the racquet sports businesses, 64 percent of the audio-visual companies, 61 percent of the veterinary services and 45 percent of the tour companies and travel agents reported that they were experiencing competition from one or more tax-exempt organizations. A majority of the respondents in each category believes that the problem is increasing. (1987 GAO study, p. 35.)

Additionally, the 1986 White House Conference on Small Business's number three recommendation, out of 60, is eliminating tax exemptions and subsidies for the commercial activities of nonprofits and monitoring by the Small Business Administration's Office of Advocacy and the Office of Management and Budget of government regulations that subsidize nonprofits. The Chamber's Board of Directors endorsed this recommendation in November of 1986.

B. The Response of the Chamber

As I am sure all the members of this Committee are aware, the Subcommittee on Oversight of the House Committee on Ways and Means issued a series of "discussion options" on UBIT, inviting comment from any interested party.

In response, the Chamber studied these options carefully and prepared a position statement. (A copy of this statement is attached.) At its June 8, 1988 meeting, the Chamber's Board of Directors adopted the statement.

I will not take time to read the entire statement, but I would like to summarize it. Before I do that, however, I would like to point out that the Chamber's position on UBIT is the result of a long, deliberative process in which we resolved the mutual concerns of our small business membership and of our state and local chamber of commerce and association membership. We believe that the approach that we have outlined, if implemented, will significantly reduce the problem of unfair competition by tax-exempt organizations against small businesses. Moreover, we do not believe that the changes set forth will damage the ability of nonprofit organizations to continue effectively their exempt purposes.

To reduce the degree of unfair competition by tax-exempt organizations against small businesses, the Chamber supports strict enforcement of the current UBIT requirements. In addition, the Chamber supports modification of the law to include certain activities as *per se* unrelated. We support increased information reporting to the extent that it will permit better identification of areas where competition with small business exists. On the other hand, we oppose any effort to tax nonprofit organizations more heavily than other taxable entities as would occur if certain of the discussion options were implemented. The attached statement outlines these points in greater detail.

III. Compliance with UBIT

The IRS has only 500 agents to monitor and enforce the UBIT law. The ratio of 500 agents to the hundreds of thousands of nonprofit tax returns seems inadequate. However, adding more agents, without changing the law and regulations, would not solve the problem.

Additional resources should be spent in improving the IRS's data base on nonprofit organizations, requiring more detailed tax returns from 501(c)(3) nonprofits, which would specify the nature and source of income and the allocation of expense to offset that income.

IV. Conclusion

The issue of unfair competition between 501(c)(3)s and taxpaying businesses is an important issue for this Committee. The Chamber supports the charitable goals of 501(c)(3)s and applauds their efforts to provide as many services as possible to those in need. We are concerned, however, by the actions of those 501(c)(3)s that enter into commercial activities and, in doing so, damage another sector of our economy -- small business.

The Chamber believes that the different groups with an interest in this issue -- small businesses, the tax-exempt sector, legislators and Administration officials -- need to work together to fashion a better method of distinguishing taxable and tax-exempt activities and income. These improved distinctions will allow for-profits and nonprofits to continue their important contributions to our society.

Thank you for the opportunity to testify.

STATEMENT ON UNRELATED BUSINESS INCOME TAX FOR TAX-EXEMPT ORGANIZATIONS

The U.S. Chamber believes that the existing exemption accorded to non-profit organizations that engage in an income-producing trade or business allows some tax-exempt organizations to unfairly compete with tax-paying small businesses. Therefore, the Chamber supports revisions in the definitions and application of unrelated business income tax (UBIT) to ensure that activities carried out by otherwise tax-exempt organizations do not compete unfairly with existing for-profit enterprises. However, the Chamber believes that a vibrant, tax-exempt, non-profit sector is critical to the maintenance of a sound social fabric. We support the UBIT provisions that enable tax-exempt organizations to execute the charitable, educational, religious, scientific, social, labor, trade or other purpose for which the tax exemption is given.

To reduce the degree of unfair competition by tax-exempt organizations against small business, the Chamber supports strict enforcement of the current UBIT requirements; in addition, the Chamber supports modification of the law to include certain activities as per se unrelated (taxable):

1) Gift shop or bookstore income, with exceptions for (a) on-premise sales of low-cost mementos, (b) on-premise sales of an educational nature which relate to the organization visited, (c) in the case of a hospital, articles generally used by or for inpatients, (d) in the case of a university, articles in furtherance of educational programs (excluding typewriters, computer hardware and software), or low-cost items.

2) Income from sales or rental of medical equipment and devices (including hearing aids, portable x-ray units, oxygen tanks), laboratory testing, and pharmaceutical drugs and goods, with exceptions for inpatients or emergency treatment outpatients.

3) Income from certain health, fitness, exercise and similar activities unless program is available to a reasonable cross- section of the general public such as by scholarship or fees based on community affordability.

4) Income from travel and tour services, with the exception of services provided by colleges or universities to students or faculty as part of a degree-program curriculum.

5) Income from adjunct food sales with exception for on-premise services and/or sales provided primarily for students, faculty, employees, members or organization visitors.

6) Income from certain veterinary services such as grooming, boarding, and elective surgery, with exceptions for spaying and neutering and measures to protect the public health.

7) Income from a hotel facility which is patronized by the public, with exception for facilities operated, but only to the extent necessary, in furtherance of the organization's exempt purpose.

8) Income from theme or amusement parks.

The Chamber further supports repeal of the "convenience exception" to the application of the unrelated business income tax. The Chamber supports modification of the law so that organizations "testing for the public safety" will no longer be exempt from income taxation.

The Chamber supports increased information reporting to the extent that it will permit better identification of areas where unfair competition with small business exists. The Chamber also supports an increase in the amount of unrelated income exempt from taxation from $1,000 to $10,000 per year.

The Chamber steadfastly opposes any effort to tax non-profit organizations more heavily than other entities. Thus, we oppose proposals to allow deductions from UBIT only for direct advertising costs. Furthermore, with respect to facilities used for both exempt and unrelated business purposes, the Chamber opposes proposals to allow deductions against UBIT for a proportionate share of the direct operating cost of the facility (e.g., maintenance, insurance, and utilities), but not allow a deduction for a share of the general overhead of the organization or for depreciation. The Chamber opposes taxation of non-profit organizations' passive royalty income and trade show income because these revenues do not lead to unfair competition with small business.

Finally, the Chamber opposes any change in the law which would alter the rules pertaining to subsidiaries and joint ventures. Specifically, proposals to modify the definition of "control" in the case of exempt organizations having taxable subsidiaries, extending "control" rules, providing that a controlled taxable subsidiary's income can be no less than its UBIT would have been if the income-producing activity had been carried on directly by the exempt parent organization, and aggregating income and activities of controlled subsidiaries in order to determine if the primary purpose of the parent is tax-exempt, are unnecessary. While the Chamber believes that the current law pertaining to subsidiaries and joint ventures is adequate, we do believe that these areas should be monitored to avoid situations where the rules are abused and lead to unfair competition between non-profits and small business.

American
Healthcare
Institute

Affiliated with American Healthcare Systems

James L. Scott
President

Statement

of James L. Scott

President of the

American Healthcare Institute

on

Competition Between Non-Profits and Small Business

Before the House Small Business Committee

June 29, 1988

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Mr. Chairman, my name is James L. Scott, President of the American Healthcare Institute. The American Healthcare Institute represents a national network of 34 voluntary, not-for-profit health systems. These systems, working to provide the communities with high quality health care at an affordable price, comprise the largest network of not-for-profit hospitals in the world.

We appreciate this opportunity to share our views regarding competition between tax-exempt organizations and for-profit business activities.

As you know, Mr. Chairman, throughout the nation's history, the voluntary, not-for-profit hospital has been accorded special status because of its commitment to a broad range of charitable purposes and essential community services responsibilities. The goal of the voluntary community hospital has always been to maintain and improve the health status of all the citizens in the community by offering whatever health services are needed, irrespective of whether or not the recipient of care can pay or whether the costs of such services can be recovered.

We are proud to be part of the tax-exempt health community. This community service commitment involves responding not only to the personal health care requirements of the patients we serve, but also major responsibilities for the training of health care professionals, the conduct of research on new and innovative medical techniques, and the health education of the community at large. In a competitive environment it is not possible to charge patients an additional amount to pay the cost of community services of nonprofit hospitals that go beyond the costs of other institutions.

The Federal tax code has long recognized the importance of the voluntary, not-for-profit hospital as a resource for the benefit of society as a whole. The code imposes unrelated business taxes only on any income that tax-exempt organizations derive from activities that are not substantially related to their exempt purposes. The goal of such taxes is to prevent unfair competition within a competitive economy between tax-exempt entities and taxable businesses engaged in certain kinds of activities. But the law clearly does not impose taxes on any income derived by not-for-profit organizations where such income is related to the exempt purposes of the organizations, regardless of competitive situations. We support these underlying principles embodied in the tax code. Taxes like the unrelated business tax are not intended to hamper the tax-exempt purposes of entities such as not-for-profit community hospitals. Instead they are meant to impose taxes only on unrelated commercial activities, comparable to those imposed on taxable entities. We believe this is entirely appropriate.

Our concern, Mr. Chairman, is that Congress not overlook the importance of a health, not-for-profit sector in meeting societal goals in the broadest manner possible. The entities that make up the independent sector serve a social purpose because their benefits go to the community at large. They are publicly accountable organizations through governance structures that include local community leaders. Our health systems and their member hospitals are outlets for a wide array of voluntary efforts and have access to philanthropy and less expensive capital only because they serve the public interest, and not just the interests of private investors.

The not-for-profit hospital system in the United States enjoys special privileges, such as exemption from sales, property and federal income taxes. By granting such exemptions, the government assists communities in the development of local health resources without presuming to control them. It is the existence of a vibrant, voluntary hospital sector that also permits government to respond to the needs of the people for quality care without imposing an enormous tax burden on society overall.

Why, then, have concerns arisen about the relationship of tax-exempt and taxable organizations in a competitive environment? How are hospitals responding to changes that are hampering their ability to serve their traditional community purposes? Some of the problems, we think, stem from changing attitudes and expectations about how the hospital community should respond to changing economic and competitive conditions without compromising its historical goals. Let me elaborate.

Until the late 1960's, not-for-profit hospitals met the cost of community commitments by a combination of Federal and State project grants, the payment for billed charges from insurers and self-pay patients, annual community fund drives and other philanthropy. With the passage of Medicare and Medicaid, revenues from patient care were improved but other important sources of operating revenue, such as philanthropy, dramatically decreased in importance. Over the next few years, so also did most special Federal and State project grants except for those destined for tax-supported and publicly sponsored institutions.

Despite these changes, our hospitals were able to continue to fulfill their community missions supported largely from their incomes from private and public third party payers. However, in 1982 Congress changed the ground rules under which hospitals had previously operated when it passed the Tax Equity and Fiscal Responsibility Act (TEFRA) which had the effect of reducing our Medicare payments.

In 1983, hospital Medicare reimbursement was changed even more radically when the Congress declared that, from then on, government would determine the economic value that was to be placed on services rendered in the hospital on behalf of Medicare patients and price those services prospectively, thereby putting hospitals at risk in what was equivalent to a commercial marketplace. This pricing approach paralleled that of businesses in the private sector, who wanted their fringe benefit costs for health to reflect only the expense of their own work force, and therefore sought to purchase care directly at the deepest discounts possible. In other words, employers sought ways to pay only the marginal costs of taking care of their patients or a little more. It was as if these two principal purchasers of care, government and business, considered that healthcare of patients they were responsible for was to be treated like a commodity and someone else should take the responsibility for meeting the needs of other community residents.

To make matters even more difficult, every year since 1983, Medicare and Medicaid have been asked to absorb a disproportionate share of federal budget cuts. In 1988, for example, according to the Congressional Budget Office, Medicare accounts for about 8 percent of Federal outlays, but it will provide 16 percent of the budget cuts initiated to meet Federal deficit reduction goals -- thereby forcing many hospitals to lose money on Medicare patients and to seek to transfer to payers in the private sector the responsibility to make up for this loss.

However, Mr. Chairman, although hospitals' revenues are being constrained, we have not seen any change in the attitude of the public as to what is expected of voluntary hospitals in pursuing their traditional missions. Indeed, in most communities the public still expects local hospitals to provide a full range of health services, irrespective of whether those services are economically viable, and to provide those services whether patients can pay for them or not.

In an effort to reconcile these conflicting expectations between purchasers, who wish to pay marginal costs for their beneficiaries only, and a public that expects us to meet all of its expectations for health care, how have our hospitals and physicians responded? Clearly, hospital admissions and patient length of stay have been reduced. When it is medically appropriate, treatment of patients has been moved into a less expensive, ambulatory or alternative delivery site. But, hospital closures have also increased each year since 1983 -- and 80 facilities closed in 1987. The Prospective Payment Assessment Commission (ProPAC), notes that hospitals have reduced their capacity by more than 32,000 beds since 1983.

Our hospitals also reorganized, corporately, to reduce their administrative costs. This permitted them to take advantage of the economies of scale that come from centralized purchasing, to tighten management capabilities and share administrative expertise. Some hospitals also created not-for-profit and for-profit subsidiaries to engage in additional lines of business to generate new revenues to replace those lost as a result of the above-mentioned Federal and private purchaser decisions.

Among my own members, when these subsidiaries have engaged in unrelated business activities they have met the same corporate tax obligations as other commercial enterprises. By and large, however, such ventures are not a major factor, indeed, to the best of my knowledge, in 1987 the total earnings of such subsidiaries before taxes are still insignificant when compared to our hospital operations. The tax code appears to strike an appropriate balance between the need to support the charitable purposes and community responsibilities of voluntary, not-for-profit hospitals, while at the same time imposing appropriate taxation on unrelated business activities.

In the United States, the competitive environment affects all three sectors of economic activity -- governmental or public, commercial, and the nonprofit sector. It is impossible for these three sectors to fulfill their functions without having competition at their margins. The governmental, nonprofit and commercial sectors compete directly with one another in providing services to patients, the operation of health clubs, gift shops, subsidized parking, and restaurants. In recent years, the commercial sector has initiated competition with the governmental sector - and in a few instances with the nonprofit sector - in areas that have been traditionally noncommercial as, for instance, adjudication services, the operation of fire departments, police and security services, jails, mail, couriers and the delivery of packages. As I have observed, most of these competitive expressions occur at the margins and are, with only certain exceptions, not necessarily central to the mission of any of the three sectors.

The general public continues to expect voluntary, nonprofit hospitals to provide the services they need, irrespective of whether the services can be self-supporting or the patients can pay for them, and at the same time the delivery of health care services has been subjected to the constraints of the marketplace. Where hospitals compete for patients on the basis of price, it follows that generating new revenue for nonprofit hospitals to cover the cost of such activities as education, research, bad debts, indigent care, burn units, and neonatal intensive care has become essential.

Generally speaking, the criteria our institutions have used to determine whether or not to initiate a new line of revenue-producing business are two. They include:

1. Permanence and reliability. This has led hospitals to sometimes seek to make available to non-hospitalized persons or to other organizations some services they normally perform for their own patients. Hospitalized patients need such things as food, clean linens and medications. Hospitals need such things as billing and accounting services, safety inspections of new biomedical equipment, and emergency backup electric generators. Hospitals have sometimes offered such services to a wider market.

2. Control and convenience. Hospitals have sought to confine their new activities to services which they are able to manage well with their organizational structures and competence. Similarly, there are geographic and other circumstances that need to be taken into account in determining whether it is practical for the hospital to engage in a service.

Initiating a revenue-generating activity that meets permanence, reliability, control and convenience criteria leads some to conclude that not-for-profit hospitals have begun to resemble entities in the private-commercial sector. I would submit that very important distinctions remain, and that only an understanding of the full role of nonprofit hospitals in society can put that issue to rest. In support of this proposition, I would offer the following points for your consideration.

First, voluntary hospitals almost universally trace their roots to ownership or sponsorship by a religious entity. As such, their missions were to meet a social purpose literally as an extension of government without being under governmental control. As stated by Lester Salamon, 1987, "for better or worse, cooperation between government and the voluntary sector is the route this nation has chosen to deal with its human service problems --- this partnership has deep roots in American history, testifying to its fit with basic national values --- it is time to stop treating this partnership as an unwelcome relative and to recognize it as a more or less permanent, and quite valuable, fixture on the American policy landscape". Thus, the commitment of these institutions to meet the requirements of their communities, independent of economic considerations or the ability to pay, has been sustained throughout history.

Second, together with many public hospitals, not-for-profit hospitals are the primary site for clinical research, and educational programs for health professionals including, but not limited to, physicians, nurses, and other allied health personnel. There is insufficient capacity within the public hospital system today to accept all of these programs were they to be abandoned by the nonprofit sector; nor would they likely be accepted by any great extent by the investor-owned segment.

Third, many features are unique to the contemporary not-for-profit hospital. These institutions, for example:

- provide care to indigents - a recent study in the New England Journal of Medicine reports that uncompensated care in not-for-profit hospitals is significantly higher than that in investor-owned hospitals -- ranging from 15 percent higher in one state, to 50-100 percent higher in the other states studied;
- meet the full profile of the health needs of their communities including, but not limited to, burn units, emergency rooms, neonatal intensive care units, rehabilitation and social services, health promotion and health education, etc., services which often are not self-supporting;
- provide the sites for the development phase of new technology;
- bring the convenience of health services as close as possible to those in need; and
- serve as standard setters for all hospitals; as sites for the examination of ethical conflicts between profiting from illness and professionally driven decisions; as outlets for personal philanthropy and voluntaryism; and as sources of reinforcement for other community voluntary efforts.

Finally, almost 30 years ago the American public first declared for itself the social aspiration that access to health care should be a right. By common consensus, there is no way in which government, today, can implement such a broad and desirable social objective. That government has been able to contemplate this objective has been wholly and totally dependent upon the existence of private, not-for-profit hospitals.

Mr. Chairman, it is our summary position that in a pluralistic and multifaceted society such as our own, there will be both conflict and overlap between governmental, nonprofit and commercial sectors. In other words, some competition is inevitable and may even be desirable. Making the competition fair, consistent with permitting each of the elements of the three sectors to pursue their primary objectives is a proper objective. In this context, it is our judgment that the current Tax Code, while thought by some to be outdated in terms of the remarkable changes that have taken place in the environment, continues to serve us remarkably well. At the same time, we stand ready to refine, further clarify, and otherwise amend those points of contention that remain and will work with you and the members of your Committee to accomplish that objective.

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TESTIMONY OF

Wayne J. Smith
Chairman of the Board

SMALL BUSINESS LEGISLATIVE COUNCIL

before the

Committee on Small Business
U.S. House of Representatives

June 29, 1988

1025 Vermont Avenue, NW/Suite 1201/Washington, D.C. 20005/(202) 639-8500

My name is Wayne J. Smith and I am the 1988 Chairman of the Board of the Small Business Legislative Council. As you know, the Small Business Legislative Council (SBLC) is a permanent, independent coalition of over ninety trade and professional associations that share a common commitment to the future of small business. Our members represent the interests of over four million small businesses in manufacturing, retailing, distribution, professional and technical services, construction, transportation and agriculture. A list of our members is attached. I belong to the SBLC in my capacity as the Executive Director of the United Bus Owners of America. In that role, I have had much first hand experience with the impact of unfair competition by nonprofits. Bus owners and the travel industry have been among the principal victims of unfair competition.

SBLC is also a member of the Business Coalition on Fair Competition (BCFC) and we wish to associate our organization with the testimony of BCFC. It provides an excellent framework for understanding this issue. Several members of SBLC submitted individual statements on behalf of their industries to the Committee on Ways and Means last year. They tell the firsthand story of the harsh reality of unfair competition in the marketplace, we will not attempt to recount their concerns here.

As I am sure many will mention today, the issue of unfair competition by nonprofits emerged as the third highest priority at the 1986 White House Conference on Small Business. The story of the Conference however is the intensity of the interest in this issue within the small business community. We had the privilege of participating in the proceedings of the 1986 Conference and the predecessor conference in 1980, and have been a first hand witness to the growing concern of small business in this matter. At the 1980 Conference, this issue was discussed only in conjunction with a companion issue, which I will address later in my testimony, direct competition by government, and did not receive any attention in the final fifteen top recommendations of the Conference. We were only beginning to understand the scope and nature of the problem at that time.

By the 1986 Conference, however, unfair competition by nonprofits had reached epidemic proportions. Some of the most lively debates at the 1986 Conference centered on this issue. What we found most remarkable was the diversity of the businesses that share this problem. More often than not, we heard the refrain, "I have the same problem, but I did not think anybody else did, and I did not know what to call it." Among the industries identified by the participants were: food service, testing laboratories, retail sales of books and computers, travel recreation, nurseries, day care, hearing aids, veterinarians, blood banks, consulting engineers, medical equipment suppliers, pencil makers, specialty advertisers, hotels, bus operators, printing, construction, laundries, janitorial services, waste hauling, electrical, plumbing and heating contracting to name a few.

I would like to devote my testimony to two specific aspects of the unfair competition by nonprofits issue-a non price unfair advantage enjoyed by nonprofits, and why unfair competition is a "small business" issue. If I may put the cart before the horse, I would like to explain first the advantages enjoyed by nonprofits that create unfair competition before I discuss why unfair competition is a small business problem.

Small businesses constantly seek the competitive edge; if not for competition, small business would not have earned its reputation as the leader of innovation. After a new or better product, quality and service are frequently cited as the means to gaining the competitive edge. I do not believe for a moment, that any small business would complain if a nonprofit garnered marketplace on the basis of innovation, quality or service.

Price, of course, is the other significant factor in any competition for market share. The hearings before the Committee on Ways and Means focused on the single most important contribution to the nonprofit's ability to control costs and hence price - namely the exemption from federal taxation. Other factors that permit a nonprofit to reduce costs artificially include postal subsidies, local property exemptions, and cross subsidization. We do object strenuously to the use by nonprofits of government sanctioned means to lower prices.

When we first set out to examine the problem of unfair competition we began with the assumption that nonprofits gained market share by manipulating price through these cost advantages. As we continued to uncover stories of unfair competition, we learned that in many cases, prices for services offered by nonprofits were not significantly lower, and in fact, prices of the nonprofits were actually higher. Why then, did the market share of the nonprofit increase? We can come to only one inescapable conclusion. The imprimatur of government approval, or even the use of the term "nonprofit" provided the nonprofit entities an unfair advantage.

We refer to this phenomenon as the "halo" effect. The irony is that some academicians have used a version of this concept to explain why some nonprofits exist. The simplified summary of the theory is that the public confidence demands that some services must be provided without profit motivation, that somehow a profit motive will jeopardize the quality of the service as for-profit providers cut costs to increase profits. Of course, we do not believe such a correlation can be proven.

The plain fact is that some nonprofits have turned this "halo" into a marketing tool. The names of nonprofits appear on everything from tours to health newsletters. Whether it is in the belief they are "doing good," to feel safer, or otherwise protected, consumers will buy from a nonprofit even when the nonprofit offers services at a higher price.

It does suggest, that at a minimum, we must be more careful in granting any government recognition to an entity and ensure that the status, once granted, does not become solely another unfair advantage.

If I may now address the issue of why this is a uniquely small business problem, let me say that it should come as no surprise to learn of small business' interest in unfair competition. The ability to compete on a level playing field is of paramount importance to smaller firms. Small business does not ask government for much but it does expect government to provide for fair competition. Our organization has a long history of pressing for the vigorous enforcement of antitrust laws for many of the same reasons which prompted us to appear here today.

Several factors contribute to make unfair competition by nonprofits a small business problem. Most prominent among them is the fact that small businesses dominate the service sector. Easy of entry, low capital costs, and a premium on human resources make the service industries ideal spawning grounds for small businesses. Although it is a little like the debate over what came first, the chicken or the egg, the expanding role of small business in the service sector coincides with the movement of our economy towards a service based economy. Its hard to say what came first, but the bottom line is small business *is* the service sector. At the same time, the nonprofit community is best suited for expansion into service markets. Universities, hospitals and other nonprofits have the facilities and the personnel, it is only a matter of applying a little creative foresight to develop new markets for nonprofits. The reasons for their expansion are obvious-declining revenues, increased costs and excess capacity. From that perspective its hard to find fault with the nonprofits; we would expect any small business to apply the same business strategy, the only problem is that the nonprofit applies the strategy without economic responsibilities.

Another factor contributing to the disproportionate impact on small business is the fact competition takes place in local markets. Professional and technical services, on the whole, do not lend themselves to national marketing strategies. Unlike a product which can be placed in the stream of interstate commerce, service does require "personal" delivery and thus competition generally pits one nonprofit against one local segment of the for-profit community.

The problem is that we have an economic sector which is turning a considerable "profit" at the expense of the taxpayer and the small business community. At one time charitable entities had clear purposes and clear means of support. Now it is an industry with unrestrained growth. It is unregulated for all intents and purposes. Subchapter F of the Internal Revenue Code includes 25 specific categories of exempt organizations. Nearly half of all tax-exemptions are granted to organizations under the criteria of Code Section 501(c)(3) for religious, charitable, scientific or educational purposes. It is these 501 (c)(3) organizations that generate most of the competition with for-profits. Section 501(c)(3) organizations are generally service oriented, that is they generate revenue by providing services for a fee, and thus are more likely to compete for business. Hospitals and educational organizations account for 36 percent and 17 percent of total tax-exempt revenue, respectively.

Let me make it clear that we support the role of nonprofits in our society. Let me also make it clear that the universe of nonprofit unfair competitors is small. We acknowledge the importance of the independent nonprofit sector and its essential contributions in education, basic research, and charitable endeavors. We are particularly proud of the participation of our small businesses in charitable endeavors. Universities educate the highly trained engineers, scientists and other professionals needed for the jobs of the future. Nonprofit trade and professional associations promote professional and ethical conduct as well as improvements in the quality of goods and services. Volunteerism is very much a part of our way of life in this country. The balance between self reliance and the common good makes our economy unique. Small business is a vital component of volunteerism. Small business owners are leaders in their community. The poster in the local appliance store heralding the next bake sale and time spent on the board of the local hospital represent the spirit of volunteerism, and they serve to illustrate the pervasive and integral role of small business in local charitable endeavors.

It is not a comfortable position for small business to challenge traditional notions of charitable endeavors. It is after much discussion and debate we do so. In the end, however, we come to the inescapable conclusion that the costs to small business and the economy have become too great whenever nonprofits can conduct commercial activities without restraint. We believe the revenue raising activities of nonprofits can be channeled into appropriate methods without jeopardizing the future of volunteerism.

Much has been written and said about the "players" in this issue. The issue of unfair competition is not directed at trade associations. Trade associations are not unfairly competing with small business. Although trade associations and other nonprofits are governed by the same rules, an examination of the testimony before the Committee on Ways and Means reveals the true nature of activities which result in unfair competition. These activities include laboratory testing, travel services, laundries, hearing aid and medical sales, veterinary services, and physical fitness and recreation services. The most frequently mentioned competitors were universities and hospitals. These entities are not associations. However, through activities like those outlined above, they have become small businesses under the "nonprofit" heading.

Your invitation to appear today included an invitation to comment on all aspects of unfair competition including the problem of competition by the government, and we would like to take the opportunity to do so.

Throughout our economic history we have used the term unfair competition portray a multitude of problems. In recent years it has been used most frequently in conjunction with three specific problems which share a common denominator. Each of these unfair competition problems constitutes a significant shift in economic activity. The unfair competition, to which most of our testimony today has been devoted, occurs when nonprofits provide goods and services to the public in direct competition with private, for-profit firms. The second type of unfair competition is competition from regulated monopolies. This competition results when utilities use rates to subsidize heating and cooling construction "subsidiaries". Finally, we use the term to describe the situation in which the government conducts commercial activities that it could obtain from the private sector. It has been estimated that government competition with the private sector costs the taxpayers $2 to $3 billion annually in the federal budget.

Unfair competition may occur when the government conducts activities in-house which could be obtained from the private sector. Over the years these activities have multiplied in number and include such diverse activities as custodial services and nursery farming. The only federal policy on this subject is an administrative regulation known as OMB Circular A-76. The purpose of the circular is to identify commercial activities that the government does conduct in-house and then to require the agencies to conduct a cost comparison between government performance and business performance.

Unfortunately, A-76 has failed to live up to its charter. Without the force of law behind it, agencies have circumvented the intent of the circular. When the rules of A-76 are applied they are so fraught with loopholes few cost comparisons reflect accurately the efficiency of contracting out activities.

In recent years the General Accounting Office (GAO) has issued reports that have consistently demonstrated a national legislative policy of reliance on the private sector is necessary in order to stem the tide of in-house commercial activity. In its most recent study, entitled "FEDERAL PRODUCTIVITY: Potential Savings From Private Sector Cost Comparisons," the GAO estimated the savings to the government could range from $2 to $3 billion.

Congressmen Bob Smith (R-OR) and Charles Stenholm (D-TX) introduced legislation in the 99th Congress that would have codified and improved the A-76 process. They reintroduced the "Competition Savings Act of 1987," H.R. 1606, in the 100th Congress. H.R. 1606 is a further refinement of their original concept. SBLC has been one of the principal private sector supporters of their initiatives. The authors are currently seeking co-sponsorship by other Members of Congress.

The purpose of the legislation is to identify the "commercial activities" of the federal government (those activities now performed by federal employees which could be done under contract to the government by private business); to expand the use of competitive cost comparisons between qualified federal and private sector providers as a means of identifying the government's "most efficient organization;" and to promote the award of contracts for performance of such work to the most efficient qualified provider, federal or private.

The goals are cost savings and program preservation. Because the bill seeks only to increase efficiency through competition, a second anticipated goal, according to the aforementioned GAO report, would be preservation of programs which might otherwise fall victim to deficit reduction efforts. OMB concurs with the GAO findings.

The Smith-Stenholm bill is the successor to efforts by Sen. Warren Rudman in the 98th Congress, and Sen. John East and Sen. S. I. Hayakawa in the 97th Congress. It has been with some disappointment we view our own failure to ignite congressional interest in this serious problem.

Most recently, the President's Commission on Privatization has made recommendations on the subject. Specifically, the Commission stated: "The federal government should rely on the private sector for provision of commercially available goods and services. Because contracting provides a means to procure the same level of service at reduced cost, it is not in the public interest for government to perform functions in competition with the private sector."

The government's track record in this important area is dismal. As early as 1933 a Special House Committee reported on the growing number of commercial activities being performed by the government. (House Special Committee, Government Competition with Private Enterprise, 72 Congress, 1st Session, House Report 235) Even then the list of activities was quite extensive.

During the 1950's Congress and the Executive Branch undertook the first major effort to grapple with this problem. In 1954, the House Committee on Government Operations issued a report entitled "The Government in Business." The first sentence of that report stands today as topical as the day it was written. The committee stated: "The subject of Government in Business is wide in scope and extremely important in this era of big government debts, heavy taxes, and complex intergovernmental relations." The Report quoted Thomas Jefferson, James Madison, Alexander Hamilton noting that the "Founding Fathers did not conceive that the federal government would engage in business in competition with citizens striving for a livelihood."

The committee observed that in 1953 the government operated over 100 business type activities and recommended that the government should stop competing with the private sector. In its conclusion, it made a statement which perhaps best summarizes the concerns of the business community. The committee stated: "Genuine efforts should be exerted to encourage rather than discourage industry to handle the government's business. A strange contradiction exists where *the government gives lip service to small business and then re-enters into unfair competition with it.* (emphasis added) In 1954, the House of Representatives passed one of the first bills on this subject, but it failed to pass the Senate.

This attention by Congress did result in executive branch activity. The Bureau of the Budget issued Budget Bulletin 55-4 in January, 1955. Business' struggle to get the government to develop a cohesive, realistic management system shifted to the Executive Branch at that point and it is where we have concentrated our efforts for the last 30 years. During this period, we have lived with several versions of the Bureau of Budget's, now the Office of Management and Budget (OMB), attempt to control the growth of government's burgeoning commercial activity. The most recent version of Circular A-76 is the culmination of this process. The fact that we are no closer to solving this problem nearly 30 years later is testimony to the fact we need more than an executive policy, we need a clear mandate. Ironically, we were probably closer to a solution then than now.

The policy as stated 30 years ago in Budget Bulletin 55-4 was simple and straight forward: "It is the general policy of the administration that the federal government will not start or carry on any commercial activity to provide a service or product for its own use if such product or service can be procured from private enterprise through ordinary business channels. Exceptions to this policy shall be made by the head of an agency only where it is clearly demonstrated in each case that it is not in the public interest to procure such product or service from private enterprise."

Interestingly, the relative costs of government vs private production were introduced in 55-4 as a factor only if a product was not available at a reasonable price. "The relative costs of government operation compared to purchase from private sources will be a factor in the determination in those cases where the agency head concludes that the product or service cannot be purchased on a competitive basis and cannot be obtained at reasonable prices from the private industry."

We believe A-76 has failed to produce complete results because it is not perceived as a national priority either within the government or the private sector. As we noted earlier, a 1978 study by the General Accounting Office came to the same conclusion and recommended, as we do, the establishment of a national policy, endorsed and supported by both the legislative and executive branches. The national policy must be stable, understandable, and provide a balance among many conflicting national issues." (GAO Study 78-118, September 25, 1978)

In recent years, there has been considerable documentation of business' ability, particularly small business, to generate new jobs and to fuel the engines of our economy. At the same time we, as a nation, have raised questions about the size and purpose of our government as budget deficits of $150-200 billion dominate the headlines. Yet, we have failed to enact a policy that will help the job creators; reduce the size of government and the deficit; and, be consistent with the economic philosophy of the founding fathers of this country. It is difficult for the business community to understand the government's inability to develop and implement sound management concepts. We can see no better way to maximize the effective use of our nation's resources than focusing the attention of the government on the act of governance and leaving the job of commercial activity to the private sector. Our founding fathers recognized that business should be left to business. Thomas Jefferson once said, "the true theory of our Constitution is surely the wisest and best, that the states are independent as to everything within themselves, and united as to everything respecting foreign nations. Let the General Government be reduced to foreign concerns only, and let our affairs be disentangled from those of all other nations, except as to commerce, which the merchants will manage the better, the more they are left free to manage for themselves, *and our General Government may be reduced to a very simple organization, and a very inexpensive one; a few plain duties to be performed by a few servants.*" (emphasis added)

Thank you for the opportunity to discuss unfair competition by nonprofits and the government.

Small
Business
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Members of the Small Business Legislative Council

- Alliance of Independent Store Owners and Professionals
- American Association of Nurserymen
- American Consulting Engineers Council
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- American Floorcovering Association
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- Architectural Precast Association
- Associated Builders & Contractors
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- Association of Physical Fitness Centers
- Association of Small Business Development Centers
- Association of the Wall and Ceiling Industries-International
- Automotive Service Association
- Automotive Warehouse Distributors Association
- Building Service Contractors Association International
- Business Advertising Council
- Christian Booksellers Association
- Electronic Representatives Association
- Florists' Transworld Delivery Association
- Helicopter Association International
- Hobby Industries of America
- Independent Bakers Association
- Independent Bankers Association of America
- Independent Insurance Agents of America, Inc.
- Independent Medical Distributors Association
- Independent Sewing Machine Dealers Association
- International Association of Refrigerated Warehouses
- International Bottled Water Association
- International Communications Industries Association
- International Fence Industry Association
- International Franchise Association
- International Reciprocal Trade Association
- Latin American Manufacturers Association
- Machinery Dealers National Association
- Manufacturers Agents National Association
- Mechanical Contractors Association of America, Inc.
- Menswear Retailers of America
- National Association for the Self-Employed
- National Association of Aircraft and Communication Suppliers
- National Association of Brick Distributors
- National Association of Catalog Showroom Merchandisers
- National Association of Chemical Distributors
- National Association of Development Companies
- National Association of Home Builders
- National Association of Investment Companies
- National Association of Manufacturing Opticians
- National Association of Personnel Consultants
- National Association of Plumbing-Heating-Cooling Contractors
- National Association of Realtors
- National Association of Retail Druggists
- National Association of Small Business Investment Companies
- National Association of the Remodeling Industry
- National Association of Truck Stop Operators
- National Association of Women Business Owners
- National Candy Wholesalers Association
- National Campground Owners Association
- National Chimney Sweep Guild
- National Coffee Service Association
- National Council for Industrial Innovation
- National Electrical Contractors Association
- National Fastener Distributors Association
- National Grocers Association
- National Independent Dairy-Foods Association
- National Machine Tool Builders' Association
- National Motorcycle Retailers Association
- National Moving and Storage Association
- National Office Products Association
- National Parking Association
- National Precast Concrete Association
- National Shoe Retailers Association
- National Society of Public Accountants
- National Tire Dealers & Retreaders Association
- National Tooling and Machining Association
- National Tour Association
- National Venture Capital Association
- Opticians Association of America
- Petroleum Marketers Association of America
- Printing Industries of America, Inc.
- Retail Bakers of America
- Small Business Council of America, Inc.
- Smaller Manufacturers Council
- Society of American Florists
- Specialty Advertising Association International
- United Bus Owners of America

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STATEMENT OF THE

AMERICAN COUNCIL ON EDUCATION

BEFORE THE

COMMITTEE ON SMALL BUSINESS

U.S. HOUSE OF REPRESENTATIVES

HEARING ON NONPROFIT COMPETITION

JUNE 29, 1988

PRESENTED BY

DR. CASPA L. HARRIS, JR.

EXECUTIVE VICE PRESIDENT

THE NATIONAL ASSOCIATION OF COLLEGE AND UNIVERSITY OF BUSINESS OFFICERS

WASHINGTON, D.C.

ON BEHALF OF:

American Association of Community and Junior Colleges
American Association of State Colleges and Universities
Association of American Universities
Association of Catholic Colleges and Universities
Association of Jesuit Colleges and Universities
Association of Urban Universities
Council for Advancement and Support of Education
Council of Independent Colleges
National Association for Equal Opportunity in Higher Education
National Association of College and University Business Officers
National Association of College Stores
National Association of Independent Colleges and Universities
National Association of State Universities and Land-Grant Colleges
National Association of Schools and Colleges of the United Methodist Church

Committee on Small Business
U.S. House of Representatives

Hearings on Nonprofit Competition
June 29, 1988

Statement of Caspa L. Harris, Jr.
on behalf of
The American Council on Education

On behalf of the American Council on Education, a higher education association representing over 1,500 colleges and universities, and the associations listed on the cover sheet of this testimony, I am pleased to provide information on the role and mission of higher education and how colleges and universities are structured to provide essential services to accomplish their mission. Within this context I will address the issue of business competition, as you have requested.

Mr. Chairman, for 25 years I served Howard University as its chief auditor, comptroller, vice-president for business and fiscal affairs, treasurer, and law professor. I am now the executive vice president of the National Association of College and University Business Officers. It is my sincere hope that my testimony will shed some important light on this complex and sensitive subject, and that the Committee, through these hearings, can help enhance the mutual trust and respect which has traditionally characterized the relationship between the higher education and the small business communities. There is much we share in common, and, by working closely together, our mutual interests can be accommodated.

In discussing the business competition issue, it is worth noting that we have worked closely with the House Ways and Means Oversight Subcommittee to identify ways of responding to concerns about competition through revisions to the unrelated business income tax. We are on record in support of many of its preliminary recommendations for changes in the unrelated business income tax, and would like to emphasize that higher education is quite willing to be held accountable for both its tax-exempt and non-exempt activities.

There are some in the small business community who believe that higher education institutions intentionally undertake competitive practices that harm small businesses. Although I am not here today to respond to any specific allegations, I can tell you I know of no specific instances where colleges or universities have willfully undertaken income-generating activities in order to compete with a private-sector entity. However, as I testified in May to the House Ways and Means Oversight Subcommittee, higher education is willing to acknowledge that some errors of judgment have been made. We are also willing to acknowledge that there have been instances of excessive zeal in some revenue-generating programs conducted on some of our campuses. As I have testified before, we support the Ways and Means Subcommittee's recommendations to increase disclosure and accountability requirements on the part of exempt organizations as a way to help prevent such overzealous behavior in the future.

I would also like to state that institutions are prepared to pay taxes on non-exempt activities as the law prescribes. We accept, for example, the Oversight Subcommittee's proposals to tax revenue from adjunct food sales, public patronage of hotels run by institutions, travel services not related to educational functions, and affinity card arrangements. We do not believe that computers should be sold to the general public and we do believe that reasonable limitations on sales of computers to students should be adopted. We further support application of the unrelated business income tax to routine testing income, so long as the statute provides a clear basis to distinguish routine testing from testing incident to research.

Mr. Chairman, I do not believe that the answer to the concern about business competition between the for-profit and non-profit communities and any related problems lies, in adopting legislation which further attempts to define and regulate what is fair and what is not. Rather, we believe the answer lies in promoting greater understanding, communication and cooperation between higher education and small business, particularly at the local level between individual institutions and their surrounding small business communities. There are sound reasons for both higher education and small business to recognize each other's legitimate concerns and to work together to resolve these concerns on a case-by-case basis. We believe this would be a positive remedy and is one of the reasons that NACUBO developed and published business competition guidelines for colleges and universities last year.

One way to approach the discussion of business competition is to briefly address the rationale behind why colleges and universities receive tax benefits. Higher education satisfies its exempt purposes through the pursuit of three traditional functions: instruction, research, and public service.

To begin with, instruction is at the core of higher education. This function cannot, however, be carried out in a vacuum. Students must be housed and fed, books and supplies must be made available, the work of the faculty must be facilitated and accommodated, and other basic needs must be met. To meet these demands, colleges and universities have traditionally provided support services such as dormitories, cafeterias, bookstores, health-care services and parking garages, for their students, faculty and staff. It is important to note that these services are provided by colleges and universities on a long-term basis, whether or not undertaking such support operations is in the college or university's best economic interest.

A second major service provided by our nation's institutions of higher learning is the conduct of research, which results in the creation and advancement of new knowledge. Both the federal government and private sector have long recognized higher education's important role in conducting research through the awarding of grants and assistance to help develop new technologies in important areas of national concern. In turn, university research has fostered significant improvements in our society, particularly in the areas of health, science, defense and business. Through its technological transfer to the private sector, research undertaken at a great number of institutions has led to many successful business-university partnerships, and the development of research products later advanced successfully through the private sector.

The third mission of higher education is its commitment to public service. Consistent with this long tradition, colleges and universities provide such diverse services as continuing and adult education programs, technical assistance to various segments of the community such as health clinics that provide assistance to low-income individuals, and music and theater events. In many areas, both rural and urban, the college or university is the center of the community in both a social and economic sense. Often times it is the sole source of critically needed educational support to the surrounding business community.

As part of their public service mission, colleges and universities are hosts to a growing number of small business development centers sponsored by the Small Business Administration. As you are aware, these centers provide economic analysis and counsel, information specialists and counseling services, and laboratory and adaptive engineering facilities to small businesses. Other examples of services provided by higher education to support small business include state-funded agricultural and economic assistance programs, which provide an important source of direct aid to help maintain a strong economic climate for business development, technological extension programs, which provide assistance to companies that cannot afford in-house expertise, and university-industry research programs where selected entrepreneurs present their business plans to potential investors.

In all three functions of instruction, research, and public service, higher education has set out to meet the demands placed upon it by our society to provide the best educational system in the world. The United States is one of the few countries in the world that depends significantly on non-government resources to provide the country's higher education system. This is clearly our objective, and is affirmed by federal and state tax exemption. Likewise, the small business owner also fulfills a great need of our society and in so doing, shares a common interest with higher education in providing for its unique constituencies.

There is great diversity within higher education today, making it difficult to offer a single prescription for accommodating small business concerns about competition. Higher education is comprised of public and private institutions -- small and large -- located in urban and rural settings. Each determines its own unique educational objectives and responds to the needs of its varied student population and its community -- local or national -- as necessary. In addition, institutions often utilize the surrounding community resources in order to provide for their students, faculty and staff.

We recognize that the small business community can provide important services to campuses and students. We believe that colleges and universities should seek out and support small business owners within their communities as appropriate. However, we also feel strongly that individual institutions must maintain the right to make decisions on whether or not to utilize a particular business resource based on their own best judgment. We feel this process is no different from that used by any other business which must make sound cost-effective and efficient decisions.

In recent years, higher education has experienced a combination of increased costs and reduced federal and private support. Any good business owner knows that to address this problem requires a combined effort to reduce costs and/or increase revenues. Institutions must expend a large percentage of their resources to attract strong faculties and provide basic up-to-date educational tools and equipment. In addition, costs to provide day-to-day operations of colleges and universities, such as telephone service, heating and air conditioning, and campus security, have been increasing each year. I am sure this has also been true for the small business owner. It is well known that tuition charges have steadily increased to help defray many of these costs. Mr. Chairman, I provide this assessment of some of the current problems facing higher education to you simply to illustrate current conditions within higher education and their relationship to the issues being addressed by the Committee.

In closing, I would briefly like to explore possible policy solutions to the issue of business competition. As I mentioned earlier, higher education strongly supports the position that any concerns about business competition between small business and colleges and universities should be resolved by the principals directly affected, and not through overly prescriptive federal or state laws. Yet, to establish an environment where both sides can sit down and discuss their particular concerns requires certain prerequisites. I would like to take a moment to suggest several of the actions that I believe would facilitate the communication process between higher education and small business.

First, it is the duty of the leaders within the higher education and small business communities to make a commitment to encourage greater communication and to create a structure to facilitate problem solving between those specific institutions and business owners experiencing difficulties at the local community level. I cannot over-emphasize this point. Often it is the case that simply bringing the two affected parties together to discuss their difficulties leads to an amicable resolution for both sides. This may sound self-evident, but we feel this is an essential step toward resolving a great many of the business competition problems that exist today between small business and higher education.

Second, it is the shared responsibility of business and education leaders to make their constituencies acutely aware of the sensitivities existing within both communities. NACUBO, in addition to publishing specific guidelines for colleges and universities to follow when undertaking income-generating activities, has held and will continue to hold national workshops and seminars on complying with the existing unrelated business income tax laws and working with the small business community. Mr. Chairman, more of these kinds of professional development activities need to be provided by both communities, as well as sponsored through the Small Business Administration.

Third, national business and education organizations should meet on a regular basis to hear concerns and respond to them accordingly. A model of this type of interaction has already been established through several meetings that have taken place, and which we plan to continue in the future, between the Business Coalition for Fair Competition and NACUBO. What we have discovered as a result of these meetings is that although we may have differences of opinion, we clearly understand the rationale behind our actions and appreciate each other's legitimate concerns. Having the two communities meet regularly, we believe, will directly and positively affect what takes place at the state and local levels.

Finally, both sides should recognize that we share a ground of common interests, and that much can be gained by understanding and supporting each other's primary objectives.

Mr. Chairman, I would like to thank you and the Committee for providing me this opportunity to express the views of the higher education community here today. I hope my suggestions in this testimony and your review of this issue will, in fact, advance an atmosphere of mutual trust and respect that should characterize the relationship between higher education and small business. I will be happy to respond to any questions you may have and to provide additional information upon request.

AMADOR

Statement of
Daniel D. Hoolihan
Associate and Chief Operating Officer
Amador Corporation

INTRODUCTION

Mr Chairman and Members of the Subcommittee:

My name is Daniel D Hoolihan and I am pleased to have an opportunity to appear before the Subcommittee on behalf of Amador Corporation at the request of the American Council of Independent Laboratories ("ACIL") to review the federal tax treatment of Underwriters Laboratories ("UL") and similar tax exempt organizations that have tax exempt status under the "testing for the public safety" exemption in Section 501(c)(3) of the Internal Revenue Code. I am presently the Chief Operating Officer of Amador Corporation, a for-profit Independent Test Laboratory located in central Minnesota near the Minneapolis-St Paul metropolitan area.

Amador Corporation specializes in testing electronic products for regulatory compliance with rules that are promulgated by agencies such as the United States Federal Communications Commission ("FCC") and foreign countries Postal Telephone and Telegraph ("PTT") Departments. This testing is done in the narrow niche of Electrical Engineering called Electromagnetic Compatibility ("EMC") Engineering. EMC Engineers are only 1% of the population of worldwide Electrical Engineers and are concerned with Electromagnetic Interference ("EMI") from one electronic product to another electronic device. In Japan, the same specialty is referred to as Environmental Electromagnetism; we EMC Engineers are very involved in the unintended releases of Electronic Pollution. Amador Corporation is an accredited laboratory with the United States Department of Commerce under its National Voluntary Laboratory Accreditation Program (NVLAP).

ACIL is an association of independent, commercial, tax-paying laboratories engaged in testing, analysis and research for external clients, both governmental and private. Founded in 1937, the association represents over 330 member firms that operate over 1000 of the nation's leading scientific and technical laboratories located in nearly every state in the Union. These laboratories are mostly SMALL BUSINESSES; they cover a wide range of technical testing disciplines including electrical, mechanical, chemical analysis, acoustical, construction materials, biological, optics, photometric and thermal.

Amador Corporation is a SMALL BUSINESS with annual revenues of approximately two million dollars per year. As a principal of Amador, I am concerned about tax exempt organizations offering EMC Engineering services similar to Amador's at lower prices due to subsidies from other parts of the agencies profitable "testing for the public safety" operations.

Let me make it clear that my concern is with "commercial" nonprofit organizations; that is, nonprofit organizations that provide services to the public almost exclusively on a fee-for-service basis and receive little or no donative financing. I am not concerned with nonprofit organizations, such as traditional charities, that rely heavily on philanthropic donations for their support.

A COMPARISON BETWEEN UL AND AMADOR

UL is a single large nonprofit business offering Testing and Engineering Services in EMC Engineering as well as numerous other Engineering Disciplines. Amador Corporation is one of many for-profit SMALL BUSINESSES located within the United States offering Testing and Engineering Services in the technical area of EMC Engineering.

Specifically, UL (a business with revenues of $160 million dollars per year) offers EMC Engineering Test Services at a steep discount to Amador's standard prices for similar services. For example, the EMI Test Laboratory of UL located near Chicago offers testing services in EMC for approximately $1000 for a normal 8-hour shift. Amador's standard prices for this testing service range from a minimum of $1600 to a maximum of $2500 for a normal 8-hour shift (depending on the size and complexity of the product involved).

The more traditional lines of UL's business are electronic, electrical, and marine safety. In several of these fields, UL is also expanding aggressively and competing with more and more tax paying companies. For example, the EMI Engineering Service has been offered in the Chicago area only since 1987.

UL offers these EMI testing services through a specialized test facility which cost approximately $1,000,000. Amador offers the same service through a specialized test facility that cost approximately $1,000,000.

UL funded their construction by using retained funds generated through their normal Product Safety Engineering activities. Amador financed their building primarily with borrowed money from the commercial banking system.

UL uses the most modern EMI test and measurement equipment available in their test facility and bought it with retained funds. Amador uses the most modern EMI test and measurement equipment available in their test facility and bought it by borrowing additional money from the banking system. (In addition to paying the full retail price, Amador paid the State of Minnesota a sales tax equal to 6% of the full retail price on each piece of equipment it bought. As far as I can tell, UL paid no sales tax on its equipment purchases.)

UL offers compliance testing for Electromagnetic Emissions to FCC Part 15 (Computers and other Radio Frequency Devices), FCC Part 18 (Industrial, Scientific and Medical Equipment), and FCC Part 95 (Receivers). Amador offers compliance testing for Electromagnetic Emissions to FCC Parts 15, 18 and 95.

UL offers testing to EMI standards on Industrial, Scientific and Medical Equipment to be marketed in West Germany. Amador offers testing to EMI standards on Industrial, Scientific and Medical Equipment to be marketed in West Germany.

UL offers witnessed testing (an engineer from a West German Lab, the VDE Lab, witnesses the testing) for West German EMI requirements for commercial computers; this service is based heavily on past UL and VDE cooperation in the Product Safety areas. Amador offers witnessed testing for West German EMI requirements based on a nine-year association with the VDE. In the first six months of 1988, Amador was allocated 7 weeks of VDE witnessed testing (all of which was sold out). Unfortunately, in the first six months of 1989, Amador was allocated only 3 and one half weeks of VDE witnessed testing due to commitments by the VDE to other labs, one of which is UL, in the United States.

Because of the favorable Dollar-Deutschmark ratio, Amador has a waiting list of customers desiring to use the VDE witnessed testing. To our dismay, we will have less time to sell in 1989 than in 1988 with a corresponding decrease in our corporate revenues.

UL tests telephone equipment to FCC Part 68 (Telephone Interconnect) requirements; so does Amador.

UL makes a "profit" on its testing services (approximately 14 million dollars in 1987); Amador makes a profit on its testing services. UL pays no income tax on its "profits"; Amador pays both a state tax and a federal tax on its profits!

UL advertises its new EMI Engineering Services through direct mailings to potential customers at a reduced non-profit postal rate. Amador Corporation advertises its EMI Engineering Services through direct mailings to potential customers at prevailing commercial postal rates.

UL does a significant amount of Engineering Standards development and production. Amador also contributes and supports Engineering Standards efforts on both the national and international levels. Amador employees are represented on standards development committees on such organizations as the American National Standards Institute, the International Standards Organization, and CISPR (the International Special Committee on Radio Frequency Interference). As with UL, these are voluntary contributions of Amador and its staff.

FOR-PROFIT OR NONPROFIT

UL was formed in 1894 and in the first decades of its existence was a not-for-profit on the basis that its mission was "scientific". Over time, it became clear to the IRS that the testing and certification work of UL was more a commercial business than a scientific endeavor. Accordingly, the IRS revoked UL's tax exemption in 1935.

UL fought the IRS decision before the Board of Tax Appeals --and lost. It appealed that decision before the Seventh Circuit Court of Appeals. That Court upheld the IRS and Board of Tax Appeals rulings, stating unequivocally that testing is a commercial business, not a charitable "public service" activity deserving of tax exemption.

In 1954, the Internal Revenue Code was amended to extend an exemption to organizations "testing for the public safety". UL presently operates under this exemption.

UL had been taxed as a for-profit business from 1935 until 1954. Amador Corporation has been taxed as a for-profit business since its inception. My partner and I have been seriously considering applying for tax exempt status considering the similarities in our testing business with UL's EMI testing business. If UL is "testing for the public safety" then Amador must also be "testing for the public safety" because every engineering test service that Amador offers is also offered by UL!

The FCC keeps a list of EMC Labs that are registered with them for making measurements on products to be submitted for formal certification with the Commissions' Rules. There are approximately 100 labs on this list and all but two of them are either a for-profit organization or a captive laboratory of a for-profit corporation. It is conceivable that all 98 for-profit organizations would be interested in becoming nonprofit entities considering the many tax advantages enjoyed by the nonprofit groups.

SUMMARY

A SMALL BUSINESS, such as Amador, is experiencing unfair competition from a LARGE BUSINESS tax-exempt organization namely UL. Amador has under-utilized laboratory facilities yet commercial customers are going to UL for their EMI testing because they are underpricing Amador's fees. Amador must pay interest on its bank loans as well as pay income and sales taxes. UL pays no interest on bank loans (because of its large cash reserves of $60 million dollars) and UL pays no income or sales taxes (because of its tax-exempt status). This competitive advantage allows them to price their testing services lower than Amador's.

This is a plea for a redemption of a tax-code exemption. The exemption for "testing for the public safety" is unwarranted. "Testing for the public safety" is a commercial activity and should be taxed accordingly. Of course, government accreditation of qualified laboratories should be emphasized and encouraged to assure the general public of quality laboratories in the area of "public safety".

On the other hand, standards development activity is a valuable engineering process that aids national and international commerce and should be tax exempt. **Many fine non-profit organizations, such as the American Society for Testing and Materials (ASTM), develop standards in a tax-exempt operating mode. They are supported financially by sale of the standards and membership fees by supporting corporations. This activity should be continued to be encouraged through the existing tax-code exemptions.**

STATEMENT OF THE
AMERICAN BUS ASSOCIATION
CONCERNING NONPROFIT COMPETITION
BY NONPROFIT ORGANIZATIONS AND GOVERNMENT ENTITIES

BEFORE

THE SMALL BUSINESS COMMITTEE

U.S. HOUSE OF REPRESENTATIVES

WASHINGTON, D.C.

JUNE 28 and 29, 1988

American Bus Association
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I am Norman R. Sherlock, President and Chief Executive Officer of the American Bus Association. The ABA represents more than 3,500 companies involved with bus regular route, tour and charter, and airport and commuter services, and in businesses that are related to travel and tourism.

During the past few years, ABA members have faced increasing competition from and lost business to tax-exempt schools, colleges, universities, churches and other groups that provide bus tour and charter service. As tax-exempt organizations, these entities enjoy tax and other advantages unavailable to tax-paying bus companies. ABA submits that when Congressional policy confers tax or other advantages on tax-paying bus companies' competitors, those bus companies cannot compete as effectively. That advantage constitutes unfair competition.

As an initial matter, ABA would like to explain to the Committee the manner by which tax-exempt organizations have entered the taxpaying bus companies' market and why the revenue earned by such commercial activity is taxable as unrelated business income under the federal income tax laws. Traditionally, schools, colleges, and churches have provided transportation for students and church-members. In either case, the tax-exempt entity had some relationship with the passengers, whether they were degree-seeking students or church members, and the transportation provided was in furtherance of the tax-exempt organization's religious or educational functions.

However, many of these tax-exempt entities are now providing tour and charter services to the general public or to tour groups -- the traditional market of tax-paying, commercial charter bus companies. Churches and schools obtain this business by promoting their charter and tour business to groups outside the school or church. These churches and schools are able to offer substantially discounted fares because of their tax-exempt status and frequently offer charter service in exchange for "donations" from passengers.

I submit today ABA's view that such commercial activity on the part of tax-exempt schools and churches constitutes unfair competition. The competition engaged in by tax-exempt organizations is unfair because: (1) such organizations do not pay federal, state, or local taxes; (2) such entities are exempt from many federal and state safety regulations that apply to private operators; and (3) non-profits benefit from exemption or special treatment under many federal and state laws. ABA submits that when tax-exempt schools and churches engage in tour and charter activity, they not only threaten the tax-paying bus industry, but also deprive the state and Federal government of substantial tax revenues, revenues to which the government is entitled and which it would otherwise receive from tax-paying bus companies.

ABA is aware of numerous schools and churches that are engaging in and promoting tour and charter activities. As many charter operators are small businesses, unfair competition from tax-exempt entities, together with other financial pressures, such as the high cost of liability insurance, is threatening the existence of many of these businesses. It should be noted that tax-exempt organizations are not required to carry the $5 million liability insurance that is required of tax-paying bus operators.

The size of the subsidized charter and tour industry is impressive. Data gathered from Federal Highway Administration sources indicate that in 1985 there was a total U.S. bus fleet of 594,000. Of this total, only 25,000 were commercial intercity buses. Roughly 323,000 were publicly owned school buses; 158,000 were privately owned, non-commercial buses and 62,000 were publicly owned transit buses. Thus, the total of non-profit buses that can be used in charter service in competition with the privately owned commercial buses is 543,000 buses, roughly 20 times the size of the privately owned, commercial bus fleet.

With regard to subsidized public sector competition, this problem has been addressed effectively through regulations. Last year, the Urban Mass Transit Authority promulgated a regulation which essentially prohibits federally funded buses and facilities from being used for charter service.*/ However, the current pending House Department of Transportation FY '89 Appropriations legislation would permit certain federally subsidized tax-exempt operators to bid for charter services.

The 158,000 privately owned, non-commercial buses represent a major, subsidized source of charter service that has not been addressed. A review of FHWA data and industry sources indicate that between 25 and 50 percent of these buses are operated in interstate commerce at least once a year. Thus, somewhere around 60,000 of these buses offer direct competition to the 25,000 buses operated by private sector commercial operators.

If the Committee feels such information would be useful, ABA stands willing to help the Committee develop a comprehensive list of tax-exempt organizations engaged in provision of bus tour and charter services. For the moment, however, let me simply recite three of the many examples of this type of conduct.

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*/ Urban Mass Transit Authority -- Docket 82-1, Charter Service, 52 Fed.Reg. 1191-6, April 13, 1987.

- One ABA member reports that a small Western city operates a school bus which is used for every conceivable purpose. The bus generates only $3,600 in revenues annually. A for profit motor carrier could not operate on such a basis. Yet, this tax-exempt organization has caused for-profit bus companies to lose business.

- Another member reports that its charter rate has dropped about 70 percent in areas in which a senior citizens' center advertises charters. Although the bus service originally provided transportation for senior citizens on trips to the doctor or shopping, this member reports that the center has expanded its area to 150 miles to take in tour events, such as stage plays.

- Another member reports that a number of churches in his area operate tours on a "donation" basis. One church owns a fleet of modern tour buses. This member expresses concerns with the safety of the church buses which are not inspected by state regulatory authorities.

For purposes of the Committee's inquiry, the first issue that must be addressed is whether, in fact, nonprofit organizations benefit from federal policies and legislation. Nonprofit organizations benefit from special treatment under virtually every form of Federal legislation affecting them. While the most important is exemption from federal income taxation, nonprofits also benefit from special treatment under Social Security, unemployment insurance, minimum wage, securities regulations, bankruptcy and antitrust law, and copyright and postal rates.

ABA maintains that under the federal tax laws the tour and charter activity of tax exempt organization should be classified as unrelated business activity, and all income generated by it must be taxed as unrelated business income.

Last June, ABA testified at a hearing held by the Oversight Subcommittee of the House tax writing committee on the commercial activity of tax-exempt organizations. The Subcommittee was concerned that the tax rules governing business activities of exempt organizations had not been updated in many years and that tax exempt and charitable organizations were conducting businesses in competition with taxpaying commercial operations. ABA recommended that while the general rules on the taxation of exempt organizations should remain in place, income from travel and tour activity should be taxed.

While the Oversight Subcommittee has no direct legislative authority, it has recently put together a series of proposed recommendations for legislative changes to the full Ways and Means Committee.

In making its recommendations, the Oversight Subcommittee agreed with ABA, recommending that income from travel and tour activities should be taxed. The Subcommittee proposes to tax income from charters to tourist attractions or vacation spots. Local charitable transportation activities, such as the transportation of needy individuals to medical facilities or transportation of elderly individuals to senior citizen centers for meals would remain exempt.

One of this Committee's objectives in conducting this hearing is to identify the industries and the types of activities in which unfair competition by nonprofit organizations is perceived to have greatest impact. ABA would like to point out that not only could the business being conducted by tax-exempt organizations be carried by taxable businesses, it in fact is carried on by such businesses. In fact, but for the unfair intrusion into the tax-paying bus company's market by tax-exempt churches and schools, such services would continue to be supplied by tax-paying bus companies.

While the foregoing analysis dictates that the income derived from a tax-exempt organization's tour and charter service be declared as unrelated business income, public policy warrants the same conclusion. Because tax-exempt organizations are supported by tax deductible donations, are exempt from federal, state and local taxes, it is the taxpayer that pays for the service. Further, when tax-exempt organizations receive other governmentally-conferred benefits, such as subsidized postal rates, the tax paying postal patron must pay for the subsidy. When tax-exempt organizations compete with tax-paying commercial entities and the government is thereby deprived of tax revenues, the income-producing activities of exempt organizations are in direct conflict with federal deficit reduction policies. Further ABA believes that the present law and regulations, as interpreted and enforced, do in fact permit unfair competition. To rectify this situation, ABA offers the following suggestions: First, ABA believes that the business of tour and charter services conducted by tax-exempt schools and churches competes unfairly with taxpaying bus companies. ABA proposes that the Committee provide, through report language or otherwise, that commercial tour and charter activities of tax-exempt organizations not continue to be subsidized by the federal government. Further, ABA submits that federal regulations should not create unfair advantages for nonprofit organizations. In our industry, in particular, tax exempt competitors pose a threat in almost every area of the country.

On behalf of the ABA, I would like to thank the Committee for the opportunity to testify on this important issue.

asae

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RECEIVED

AUG 1 1 1988

Committee on Small Business

August 2, 1988

The Honorable John J. LaFalce
U.S. House of Representatives
2367 Rayburn House Office Building
Washington, DC 20515

Dear Mr. Chairman:

The American Society of Association Executives (ASAE) is a national professional society representing more than 16,000 leaders of nonprofit trade and professional associations at the national, state, and local level.

We are writing you, as a member of the Small Business Committee, with regard to the Committee's June 28-29 hearing on competition between nonprofit organizations and for-profit businesses. ASAE is very concerned about the perception that nonprofits have an "unfair advantage" through their tax status and reduced postal rates.

Over the last several years, ASAE has engaged in a dialogue with the Business Coalition for Fair Competition (BCFC), a group of associations and small businesses concerned with the competition issue. Despite its claim that nonprofit organizations in general are involved in unjustified commercial activities, the BCFC acknowledges that associations themselves are not part of the problem. In fact, there is little evidence to show that nonprofit organization activities are unfairly competitive. After an exhaustive study last year, the General Accounting Office concluded that "complete data do not exist to quantify the nature, extent, and impact" of the perceived problem.

This point was brought out plainly at the Small Business Committee hearing on June 28th. The government witnesses were unanimous in citing a lack of basic information on the nature and growth of tax-exempt organization activities, as well as their effect on taxable businesses.

In this statistical vacuum, ASAE believes that anecdotal evidence cannot constitute a valid basis for reevaluating tax-exempt organization policy or contemplating major tax changes. While it is apparent that nonprofits have expanded their income-producing activities in recent years, this does not mean that such activities are unrelated to their exempt purpose. On the contrary, ASAE believes the vast majority continue to serve the public benefit and are justifiably tax-exempt.

Congress enacted the Unrelated Business Income Tax (UBIT) specifically to prevent nonprofit organizations from competing unfairly with taxable businesses. UBIT requires an organization to pay tax on the net gain from activities that are unrelated to its exempt purpose. Significantly, this means that an activity need not impinge on a taxable business to be subject to UBIT.

Nonprofit organizations' main sources of income have traditionally been membership dues, contributions, and passive investments. However, these often have proved inadequate to meet members' needs. Tax-exempt status means that associations cannot raise capital by issuing stock. Nor can they take advantage of options available to taxable businesses: small business set-asides; loan guarantees; management assistance; tax credits and deductions; depreciation allowances; etc. In order to raise the necessary funds, therefore, many groups have turned to other activities for which they charge fees. These include: meetings and seminars; trade shows; periodicals, books and studies; and group insurance programs. In addition, some nonprofits attempt to build a reserve of funds for future growth, as well as for their survival during economic downturns.

Today, the best description of tax-exempt groups is "not for profit." That is, they do not operate principally to realize income, but do produce revenue through both dues and non-dues sources. In the overwhelming majority of cases, such activities contribute importantly to an exempt purpose, serving members' needs as well as the general public.

At the same time, associations are now paying UBIT on activities that have been deemed "unrelated." These include: advertising in association publications; group insurance programs; job placement services; and the sale of mailing lists.

It is ASAE's contention that very few nonprofit organizations are actually engaged in unjustified, blatantly competitive activities. Given the lack of evidence to the contrary, we believe it is unwise to consider tax changes that would penalize all nonprofits. If Congress were to enact such changes, the ability of associations to finance their tax-exempt mission would be compromised. This would have far-reaching consequences, since the government would almost surely have to "fill the gap" of services they now provide. Ultimately, the American taxpayer would be called on to foot the bill for any additional government outlays.

Similarly, preferred postal rates allow thousands of nonprofit groups across the country to carry on their good work at reduced cost. Yet every year the congressional "revenue foregone" appropriation faces challenges that may be "penny wise but pound foolish."

In lieu of unwarranted and haphazard changes in the law, ASAE recommends that the Internal Revenue Service gather more reliable information on nonprofit organization activities, which could serve as a factual basis for evaluating proposed changes. We also believe that administration of the UBIT statute can be improved. The IRS should strictly enforce current law and audit more returns. Any organization that is abusing its tax-exempt status or preferred mailing privilege should be dealt with in a swift and efficient manner. ASAE also recommends an effort to improve the tax-exempt community's understanding of the UBIT rules. Compliance would undoubtedly increase as a result. Finally, leaders of the nonprofit and small business communities should continue a dialogue designed to clarify the competition question and establish an appropriate way of addressing it.

Over the last two years, ASAE and its members have been assisting the House Ways and Means Oversight Subcommittee with its review of the UBIT statute. We have contributed our knowledge and understanding of the association community toward this process. Trade and professional associations are indeed a unique part of the tax-exempt spectrum. For your information, I have enclosed a one-page fact sheet on what we're all about. Also enclosed is an "Association Report" describing ASAE's recent legislative conference.

As the Small Business Committee examines nonprofit organizations and the "unfair competition" issue, I hope you will become familiar with the association community through these materials. Please consider the perspective of 600,000 associations and their millions of members nationwide.

Thank you very much. If I can answer any questions on any of the issues raised in this letter, please let me know.

Sincerely,

G. Harris

G. Harris Jordan
Director of Government Affairs

GHJ/jlg

Enclosures

cc: Members of the House Committee on Small Business

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ASSOCIATIONS: A BRIEF INTRODUCTION

WHO ARE ASSOCIATIONS? Associations are groups such as the National Association of Realtors, the YMCA, the Big Brothers/Big Sisters, the American Medical Association, the National Geographic Society, the Association of American Railroads, et al. About 40 percent of Americans belong to one or more of these groups.

HOW MANY? Of the nearly one million tax-exempt organizations in the United States, approximately 600,000 are associations: trade and professional organizations; civic and social welfare groups; business leagues and chambers of commerce; fraternal organizations; religious, charitable, scientific and educational groups.

WHAT IS ASAE? Our association, ASAE, represents 16,000 leaders of trade associations and professional societies across the country. We also represent suppliers of goods and services to the association community. ASAE members, in turn, represent a vast constituency of more than 80 million individuals and companies belonging to associations worldwide.

WHAT DO ASSOCIATIONS DO? Their activities are numerous. Associations sponsor seminars, workshops, and conventions. They publish manuals, carry out studies, and develop industry statistics. They publish magazines and newsletters, membership directories, and technical bulletins.

Associations offer group insurance plans, sponsor industry advertising (including public service ads), publish forecasts of demands and trends, and conduct research. They develop industry standards and professional credentialing, publish and enforce codes of ethics, aid consumers in resolving purchasing problems, and provide group buying opportunities. They also help their members find jobs.

Associations are very active in government affairs, offering testimony on Capitol Hill, providing input to Congress and federal agencies, distributing PAC funds, and lobbying legislators if entitled to do so by their tax classification.

WHY ARE ASSOCIATIONS TAX-EXEMPT? Associations do not exist to make a profit; their income goes directly to provide member and community services. If provided directly by government, these services would cost taxpayers a great deal. Associations are thus granted tax-exempt status under Section 501(c) of the Internal Revenue Code. The unrelated business income tax (UBIT) governs tax exemption for specific association activities, by determining whether they are substantially related to the organization's exempt purpose.

WHAT ISSUE IS CRITICAL NOW? A growing public policy debate concerns the nature and role of tax-exempt organizations generally. This debate is linked to the issue of government subsidies (e.g. through the tax code, nonprofit postal rates), and how much support is appropriate. The House Ways and Means Committee is now examining associations' non-dues sources of income, and even the concept of tax exemption itself. Public policymakers need to understand the important services that associations provide, and the rationale for continued tax-exempt treatment.

Business Coalition For
FAIR COMPETITION

Speech Prepared For:
1988 National Hearing Aid Society Convention

NONPROFIT HOSPITALS: PUTTING PROFIT BEFORE PATIENTS

By
Kenton Pattie, Chairman
State Activities of the
Business Coalition for Fair Competition

Friday, September 30, 1988
San Francisco Hilton
San Francisco, CA

1725 K Street, N.W. • Suite 301 • Washington, D.C. 20006
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ADDRESS BY KENTON PATTIE
CHAIRMAN, STATE ACTIVITIES
BUSINESS COALITION FOR FAIR COMPETITION
1988 NATIONAL HEARING AID SOCIETY CONVENTION
9 A.M., FRIDAY SEPTEMBER 30, 1988
SAN FRANCISCO HILTON
SAN FRANCISCO, CA

Kenton Pattie is the Senior Staff Vice President of the INTERNATIONAL COMMUNICATIONS INDUSTRIES ASSOCIATION (ICIA), 3150 Spring Street, Fairfax, Virginia, 22031-2399. ICIA is one of the three founding members of the Business Coalition for Fair Competition, and Pattie is co-founder of the Coalition. Pattie heads ICIA's Government Relations Department and is its chief lobbyist in Washington. He is also Director of the Coalition for Prompt Pay which campaigned successfully in 1988 to get Federal agencies to pay bills promptly. He is an expert on education, copyright, government procurement, coalition building, lobbying, and the problems of small business. Pattie writes on these subjects for various trade magazines and is frequently asked to speak on these subjects. Prior to coming to ICIA, Pattie spent almost ten years in the U.S. Senate where he served Senators Long, Symington, and Eagleton.

NONPROFIT HOSPITALS: PUTTING PROFIT BEFORE PATIENTS

The Business Coalition for Fair Competition includes over two dozen national trade associations, including the National Hearing Aid Society. Working together, we are dedicated to finding ways to neutralize the adverse effects of the commercial activities of the nonprofits on small, for-profit firms. No association has been more active than NHAS in providing leadership here is California, in other state legislatures, and in the Congress. Alice Gallagher Reed of the California Hearing Aid Society has been an outstanding spokesperson for the Coalition and presently is a member of the A.B. 944 Advisory Task Force on Competition Between Nonprofit Organizations and Small Business.

Because of their tax-exempt privileges, nonprofits and government agencies who engage in commercial activities have an unfair advantage over for-profit firms engaged in the same commercial activities. The Coalition seeks to level the playing field between the commercial activity of the nonprofits and the for-profits by examining the extent of the problem and by looking for reasonable solutions on both the Federal and state levels. This is a complex problem further exacerbated by the myriad of Federal and state laws governing the nonprofit sector.

The Coalition is mindful of the fact that this is a sensitive issue involving fine organizations on both sides of the debate. Small businesses have traditionally supported and will continue to support charitable institutions, including hospitals, and to serve on the boards of these institutions. Without the contributions of expertise and time by small business leaders, many local hospitals, for example, would function at a lower level of efficiency and service. However, the fact that we raise questions about the commercial activities of the nonprofits does not mean that we are against nonprofits, but rather that we are distressed with some of the things they are doing.

CONGRESSIONAL HEARINGS

Last year, the Ways and Means Subcommittee on Oversight of the U.S. House of Representatives held five days of hearings on the Unrelated Business Income Tax (UBIT). The Unrelated Business Income tax, or UBIT as it it commonly referred to, is the method by which the IRS attempts to get tax-exempt organizations to voluntarily declare as taxable the income from sales and services unrelated to their charter. Many tax-exempt organizations argue that all of their activities are related and thus not subject to taxation.

As of this date, the House Ways and Means Subcommittee on Oversight has not yet submitted its findings to the full Committee on Ways and Means. The 100th Congress is now in its final weeks and no further action can be expected in this session. The House Small Business Committee also held hearings on the commercial activities of the nonprofits on June 28 and 29, 1988 and has scheduled another hearing in Chicago on October 1, 1988.* Chairman John LaFalce (D-NY) has made it clear that it is his intention to make this issue a priority of his committee in the next Congress.

Many of the nonprofit witnesses appearing before the Ways and Means Subcommittee on Oversight said they pay no Federal taxes. In response to this revelation, Chairman J. J. Pickle (D TX) stated:

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* House Small Business Committee, Saturday, October 1, 1988, 8 A.M., Loyola University School of Law, Moot Court Room, 820 N. Michigan Ave., Chicago, IL 60611.

> I am alarmed that approximately half the $57 million of UBI tax collected by IRS in 1986 is attributable to only two tax cases. Further of the more than 840,000 tax-exempt organizations on record, only about 27,000 tax-exempt organizations reported that they had income producing activities subject to the tax. What do we know about the income producing activities of the other exempt organizations? This is not an unfair question considering that exempt organizations in 1985 had more than $300 billion in revenue. (June 22, 1987.)

The Coalition shares this concern and is working to get to the heart of the answer. We are encouraged that IRS is now studying the returns of 3,000 nonprofit organizations which do pay Federal taxes. But this only addresses a part of the problem. While IRS will be studying 3,000 or 11%, of those which do pay taxes, what about the other 813,000 nonprofits which don't pay taxes?

We are also encouraged by the fact that more recent figures from the IRS show there was an increase in taxes paid by nonprofits immediately following the House investigation. Congressional inquiry may be inspiring some nonprofits to quit ducking the taxes they owe. But for the majority of nonprofits, it's business as unual, selling everything from computers to hearing aids and not paying a cent of Federal, state, or local taxes.

As long as the tax laws remain as they are today, neither the IRS study nor the increased enforcement promised by IRS during the Ways and Means hearing will result in solving the problem. The Federal tax law is so generous in accommodating the "relatedness"* of an organization's business activities that it is little wonder that so few nonprofits today are paying taxes. And, given the fact that so few nonprofits pay taxes, it is no surprise that they are urging Congress to leave the "relatedness" test and the UBIT alone. It works well from the standpoint of the nonprofits, so why change it?

As long as IRS asks the question, "Is the activity related to the purpose of this organization's charter?" we will see little change in the commercial activities of the nonprofits. The problem of unfair competition will continue. On the other hand, if the IRS is instructed by Congress to add another test, "Does this activity compete head-to-head with a similar sale of a product or service offered by the private for-profit sector?" then we would see improvement and the problem would diminish to some extent.

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*"Relatedness" is a subjective test IRS uses to measure income for tax purposes. If the business activity is "related" to the main purpose of the nonprofit, no tax need be paid. If the business is "unrelated," taxes would be paid on the net income. For example, UBIT does not tax all hospital income, but only that portion generated from sale of a product or service that is "unrelated" to the mission of the hospital. This provision in the law is so vague that even IRS wants it changed, according to Robert Brauer, Assistant Commissioner for Employee Plans and Exempt Organizations who testified for the IRS on May 9, 1988, before the U.S. House Ways and Means Subcommittee on Oversight.

NONPROFIT HOSPITALS - BIG BUSINESS AND GETTING BIGGER

Before the advent of health insurance and other third party payments, hospitals were largely dependent on charitable contributions and government aid to cover their free or charity care. They were truly charitable institutions dedicated solely to the healing arts.

Hospitals today are not only big business, but they are diversifying their operations and expanding their sources of income. This is clearly evident in a statement made by James C. Crews, Chief Operating Officer of the Voluntary Hospitals of America in a video conference held on June 22, 1988. Crews concluded the conference, titled, "Threats to Hospital Diversification -- Antitrust and Tax Status Challenges From Small Business." He said:

> In closing, what you've heard today is not whether to operate diversified businesses; you know that's certainly a business decision that each hospital has to make for itself. The question is how to operate a business in an environment that may have local business competition. The answer is to provide a quality service consistent with your hospital's mission to serve your community.

The hospitals know who they are competing against: small business. The crucial element in Mr. Crews' comment is his assertion that hospitals must find a way to "operate a business in an environment that may have local business competition." Why do they insist on competing with small businesses?

Hospitals of today are not merely interested in filling a need that exists in a community, as has been the traditional role of charitable institutions. But they have expanded their focus to ways in which they can compete with existing small businesses and neither be sued by these businesses nor have to pay the Unrelated Business Income Tax (UBIT). These commercial activities of the hospitals go beyond the accepted fund-raising activities of the past -- fund-raising activities such as bakesales, giving campaigns -- to which the Coalition has no objection.

In his prepared statement before the Ways and Means Subcommittee on Oversight, Jack W. Owen, Executive Vice President of the American Hospital Association, told the committee that "It is not our intention to rebut anecdotal reports of unfair activities." (Hearings, Serial 100-28, p. 923.) By characterizing the many commercial activities of the hospitals as merely "anecdotal reports," Mr. Owen does a disservice to the many small businesses that suffer economically because of these "unfair activities." It is these small businesses that the Coalition represents. It is not surprising then, that the American Hospital Association ignores the problems faced by these small businesses. Small businesses are losing every day to the economic power and corporate clout of today's nonprofit hospitals.

Markets served by small businesses are a prime target for the hospitals to enter because the markets are so easy to enter. The service industry comprises a large segment of the small business sector and, according to the Small Business Legislative Council's (SBLC) testimony before the House Small Business Committee, "the nonprofit community is best suited for expansion into service markets." Speaking for the SBLC, Wayne J. Smith, went on to explain:

> Universities, hospitals and other nonprofits have the facilities and the personnel, it is only a matter of applying a little creative foresight to develop new markets for nonprofits.

Additionally, Smith pointed out that brunt of unfair competition falls on small business because:

> Professional and technical services, on the whole, do not lend themselves to national marketing strategies. Unlike a product which can be placed in the stream of interstate commerce, service does require "personal" delivery and thus competition generally pits one nonprofit against one local segment of the for-profit community.

This is one of the reasons that it is so difficult to quantify the impact of unfair competition. Nonprofits generally hit only a few segments of a local business community thus isolating the problem both to the type of business that is affected and isolating the problem geographically.

COMMERCIAL VENTURES OF HOSPITALS

What, then, are some the businesses that non-profit hospitals are entering? Here's a list of 37 businesses into which hospitals have expanded according to our files. Most of this expansion has taken place in the '80s. In each case, these hospital-operated businesses compete head-to-head with small for-profit businesses.

- *pharmacy business*
- *home health care business*
- *health club and fitness centers*
- *interior design business*
- *child care business*
- *helicopter transportation business*
- *hotel and restaurant businesses*
- *x-ray business*
- *computer time sales and payroll data management*
- *sale and servicing of hearing devices*
- *sale and servicing of eyeglasses and contact lenses*
- *rental and sale of home health care equipment and supplies*

- wholesaling and retailing of drugs to organizations and firms outside the hospital
- sale and servicing of orthotic and prosthetic devices
- sale of deli foods to the general public
- operation of catering service
- ownership and operation of automobile service station
- laundry business
- sale of frozen foods
- travel business
- medical office buildings
- canned soup business
- publishing and selling books
- consulting business
- training and seminar institute
- construction company
- architecture and design firm
- high-technology equipment maintenance unit
- real estate leasing
- weight control program
- marketing program sold to other hospitals
- biomedical engineering services
- debt collection business
- in vitro fertilization business
- marketing of corporate health programs
- corporate benefits counseling business
- for-profit real estate firm

The list is apparently limitless. In an article titled, "Letting Your Creativity Run Wild," (Fund Raising Management, September, 1988) the author suggests that hospitals are only limited by their imagination. As an example of creativity by hospitals Willard Bailey, the author, gives high marks to Centinel Hospital Medical Center in Inglewood, California, "which is the base of operations for world-famous orthopedic surgeons Frank Jobe and Robert Kerlan." Bailey goes on to explain the hospital's creativity in finding a business:

> They are best known for repairing the arms of major league pitchers, Tommy John of the New York Yankees being perhaps the most publicized.
>
> The Biomechanics Laboratory has capitalized upon this limelight by publishing and selling nationally a series of booklets such as The Official Little League Fitness Guide and Shoulder & Arm Exercises for Baseball Players. (Page 58.)

After an admonition that the profits could be taxable, Bailey offers this encouraging advice:

> Suffice it to say there are exceptions to exceptions, rules within rules. It's a nest of boxes. For right now, just know that there's a special place in the stone heart of the IRS for fund raisers with imagination. (Pages 58-59.)

It doesn't require much imagination or creativity to understand why the Executive Director of the American Hospital Association would tell the House Ways and Means Subcommittee on Oversight that "the unrelated business income provisions are workable."

Some hospitals, for example, now have their own audio-visual departments and do their own work, rather than contracting with a private company. One hospital (Norfolk General Hospital) in Virginia not only provides in-house service, but advertises in the local yellow pages that it will provide video production, equipment rentals, and satellite teleconferencing to the general public. In the Norfolk area there are small for-profit tax-paying firms willing to provide this service. These small firms belong to the International Communications Industries Association (ICIA). The hospital is using equipment purchased from hospital funds to compete with ICIA's private businesses members and at the same time, using nonprofit hospital personnel.

Economic Consequences of Unfair Competition

What are the economic consequences for the small businessperson when nonprofits, using their tax-exempt advantages, decide to enter into the same business?

Robin Holm, of Seattle, Washington, and in-coming President of the National Hearing Aid Society, told the Ways and Means Subcommittee on Oversight, that just three years after the nonprofit Northwest Speech and Hearing Center started its hearing aid sales program to nonhospital patients, "the hospital's clinic was grossing $1 million and had showed profits of $161,000." Her sales that same year went down $19,000. (Hearings, Serial 100-27, p. 794.)

In addition to its tax-exempt privileges, Northwest competed by using mobile testing vans "loaded with up to $70,000 in donated equipment," and has since become a "model for its tax-exempt bretheren on how to blatantly promote and sell huge numbers of hearing aids -- all shielded from taxation." (Hearings, Serial 100-27, p. 795.)

Holm pointed out to the committee that hers is not an isolated case: that tax-exempt hearing aid centers can be found throughout the nation and concluded by saying:

> Unless steps are taken soon the outcome is inevitable. Tax-exempt clinics, hospitals and universities will soon monopolize the sale of hearing aids. Tax-paying businesses such as my own will cease to exist. (Hearings, Serial 100-27, p. 796.)

In other testimony before the Ways and Means Subcommittee on Oversight, Thomas E. Inman II, of Virginia Home Medical, Newport News, Virginia, testified that after his company invested $50,000 in home infant monitors, a local non-profit hospital went into the same business with approximately $15,000 in donated funds. Inman told the Ways and Means Subcommittee on Oversight:

> As a direct result of the diversion of the donated non-taxed funds into a questionably "nonrelated" business activity, we have suffered severe business consequences. (Hearings, Serial 100-27, p. 867.)

The loses experienced by these for-profits are real, and these businesspeople represent some of the "anecdotal reports" which the Executive Director of the American Hospital Association refuses to comment on.

Using money, donations, and economic power to compete with small businesses, nonprofit hospitals are on a collision course which leads to legislation and law suits.

Resale of Drugs by Nonprofit Institutions

The resale of drugs can also be a lucrative business for hospitals. John Rector, General Counsel of NARD (National Association of Retail Druggists) in his appearance before the U.S. House Ways and Means Subcommittee on Oversight quoted Calvin Anthony, Mayor of Stillwater, Oklahoma and a member of NARD:

> Typically our members, independent retail pharmacists, pay $9-10, depending on whether they purchase directly from a manufacturer or from a wholesaler, and a nonprofit hospital pays $1 for the same prescription. In the case of Transderm Nitro, the ratio is nearly 1 to 100. Unless wholesalers or retailers purchase prescription drugs that have been illegally diverted from nonprofit hospitals, such "discounts" are unavailable to them, irrespective of the volume purchase." (Page 7.)

Commercial nonprofit organizations are able to obtain such discounts because of the 1938 Nonprofit Institutions Act which permits charitable organizations to purchase drugs at prices lower than any other buyer.

Some of the nonprofit hospitals resell the drugs and make enormous profits. Rector told the Subcommittee:

> Many of the violators are quite bold. In a January 1987 issue of the publication DRUG TOPICS, Director of Pharmacy Services at a nonprofit Rhode Island group health association bragged openly that they were diverting so-called charity drugs into health centers, each of which has a pharmacy, and "because we enjoyed the nonprofit status, we've been able to negotiate price reductions of as much as 90% off wholesale price. (Page 9.)

Rector cites a 12-bed nonprofit hospital in Florida that received a 42-year supply of one drug in a six-month period and a 38-year supply of another drug in an eight-month period. Rector said:

> In our view, no organization, including those that serve to some extent charitable purposes, should be allowed to flaunt current laws by buying and selling drugs and other products at discriminatory prices and reselling excess quantites into the diversion black market. (Page 9.)

As a consequence Congress passed, in March, 1988, the Prescription Drug Marketing Act (P.L. 100-293) which makes it a felony for hospitals to resell drugs.

Availability of Below-Cost Drugs to Nonprofits

This, however, still does not solve the problem of unfair competition. Frederick S. Mayer, pharmacist and owner of Sausalito Pharmacy in Sausalito, California, and President of Pharmacists Planning Service, Inc. described the remaining problem to the A.B. 944 Task Force on Competition Between Nonprofit Organizations and Small Business:

> Since Kaiser and many of the HMOs . . . are nonprofit they are able to purchase pharmaceuticals at $.10 on the dollar compared to the community/chain pharmacies who must pay full retail prices for the same prescription drugs dispensed in their clinics. . . . This is truly unfair since as the nonprofit HMOs and hospitals increase in number and size there exists a cost shifting to the private patient who subsidizes all research and development of the pharmaceutical manufacturers. (Page 1.)

This type of subsidy is in addition to the tax-exempt status of the nonprofit hospital.

Negative Affect of Commerciality on Nonprofits

Concern about the negative affect of the commercial activity of the nonprofits was voiced by Dennis R. Young, Director, Mandel Center for Non-Profit Organizations, Case Western Reserve University, before the House Small Business Committee:

> The one serious concern that I do have about the effect of nonprofit venture activity has to do with the possibility of corruption of the sector itself. In particular, one worries about the danger of nonprofit organizations being diverted from their social missions by becoming preoccupied with the pursuit of surplus producing activity. (June 28, 1988, page 8.)

MYTH OF THE MISSION OF THE NONPROFIT HOSPITAL

In testifying before the Ways and Means Subcommittee on Oversight, Sister

Bernice Coreil, Member of the Board of Trustees of the Catholic Health Association said that there is an essential difference between the nonprofit hospital and the for-profit hospital:

> The fundamental distinction between the not-for-profit and for-profit health care sectors is their essential purpose, their mission. The names of the two sectors provide apt descriptions of their essential purposes. The essence of the not-for-profit health care sector is that it is not-for-profit. The essence of the for-profit sector is that it is for profit.
>
> The purpose of the not-for-profit sector is for healing, for community service, and for medical education and research, as described above. The governance of our institutions by trustees, who are members of the community, and the use of community volunteers are powerful evidence of community control of and support for out institutions. (Hearings, Serial 100-27, page 911.)

However, research and actual comparison of the for-profit and nonprofit sectors indicates that actual distinctions between the groups is often non-existent and certainly not as clear-cut as Sister Coreil and the representatives of the nonprofits would have us believe. That nonprofit hospitals are for healing and for-profit hospitals are only for profit is a myth.

The California Study

One of the conclusions reached in a study, "Response to Financial Incentives Among Investor-Owned and Not-for-Profit Hospitals: An Analysis Based on California Data, 1978-82," is that both the nonprofits and for-profits had the same mix of patients:

> The mix of patients (Medicare, Medi-Cal, and other) stayed relatively constant within each sector over the period. There was little difference between the voluntary [nonprofit] and IO [Investor-Owned] sectors. Public hospitals cared for a significantly greater share of Medi-Cal patients and a lesser share of Medicare. Other (private-pay) patients also comprised relatively less of the volume for public hospitals.

Robert V. Pattison, author of the article and Vice President of the Health Services Research Foundation, states that "the previous study noted the absence of charity care provided by this cohort of hospitals," and that this study confirmed the finding. (Page 299.) The previous study Pattison refers to is "Investor-Owned and Not-for-Profit Hospitals: A Comparison Based on California Date," by Pattison and Katz, which was published in The New England Journal of Medicine, August 11, 1988.

The Harvard Study of Fourteen Major Hospital Chains

The Harvard Business Review article titled "Who Profits From Nonprofits?" (January-February, 1987) by Regina E. Herzlinger and William S. Krasker studied the performance of fourteen major hospital chains (6 for-profit and 8 nonprofit) for the years 1977 and 1981 (the California study, mentioned above, covered the years 1978-1982).

The hospital chains studied accounted for 90% of all the chain hospital beds in the for-profit sector, and 68% in the nonprofit sector, a combined total of 725 hospitals. While the California study indicated that there was no difference in the type of patient served by the different groups of hospitals, the Herzlinger-Krasker study found that:

> For-profits do not deny the poor access to care. In fact, we found the for-profits gave slightly more access to patients who carry little or no health insurance than did the nonprofits. (Page 103.)

And while the for-profits gave more access to the poor, this group of hospitals cost society and the taxpayer less in public subsidies. Comparing the cost of capital for the two groups, Herzlinger and Krasker found:

> The nonprofits required 17 cents of public investment for every dollar of their capital in 1981, whereas the for-profits required only 2 cents. (Page 100.)

Nonprofits are exempt from certain taxes, including property, income, and sales taxes, and also are recipients of other governmental subsidies, including postal rates, which allow the nonprofits to send bulk mailings at almost half the cost paid by for-profit hospitals. So while "nonprofit hospitals receive more social subsidies than for-profits," the study found that nonprofit hospitals do not "achieve better social results." (Page 96.)

Herzlinger and Krasker concluded:

> Our analysis shows that we must rethink our assumptions about the social benefits of the nonprofit hospital. Along each dimension studied, neither society as a whole nor individual patients benefit from the nonprofit form. Quite the contrary, for most variables, the performance of the for-profit hospital is superior. (Page 100.)

This ringing indictment of the nonprofit hospital substantiates our belief that if the difference between a nonprofit and a for-profit is negligible, they should be taxed the same.

California Hospitals: "In a Profit-Making Mode"

In his statement before the U. S. House Ways and Means Subcommittee on

Oversight, on June 26, 1987, Congressman Fortney H. (Pete) Stark (D CA-9), said:

> I would like to bring to the subcommittee's attention and I would ask that it be submitted in its entirely for the record, a study produced by a group sponsored by the schools of public health at the University of California in Berkeley and using data from the California Health Facilities Commission. The study shows the value of uncompensated care provided by California nonprofit hospitals. In 1984 to 1985 it was $82 million compared to combined local, State, and Federal tax exemption of $300 million.
>
> In other words, for every dollar of charity care in California, we gave away $4 in tax exemption. What I hope the committee will ask each hospital, each medical care provider as they testify today, is how many dollars of charitable care did you provide and how much tax did you provide in real estate tax, in local sales tax, in State income tax, in Federal income tax, because I think that will get the message to the industry that they are in a profit-making mode and indeed if we are going to exempt them from the tax system, it our duty to see that the community gets medical care for its dollar of tax forgiven, foregone, or rebated. (Hearings, Serial 100-27, page 767.)

In spite of the above California statistics, C. Duane Dauner, President of the California Association of Hospitals and Health Systems (CAHHS) told the A.B. 944 Advisory Task Force on Competition Between Nonprofit Organizations and Small Business on May 20 of this year that "The financial benefit of a tax exemption is offset many times over by the services rendered to society and the general public." The studies of his own state do not support Mr. Dauner's contention.

These are some the questions which the Coalition would like answered by every nonprofit hospital in the country: What have you contributed to the community in exchange for your tax-exempt status? What is the value of your contribution? What is the value of all your tax exemptions? Who benefits from these tax exemptions? Is the value of your contribution to the community greater than the subsidy you receive from tax exemptions, low postal rates, and other community and public subsidies?

The reason that the nonprofit hospitals have been exempted from paying real estate, Federal and state income and sales taxes is because they have provided services to the community that neither government nor the private sectors could or would provide. In exchange for these services, Federal, state, and local governments exempted them from taxes. But when nonprofits act like for-profits then its time that legislative bodies, Federal, state and local, reexamine the tax-exempt status of the nonprofit hospitals. Why is one group of hospitals paying taxes and another group not paying taxes when both provide the same services and benefits to the country?

Tax Burdens of Local Communities

California is not the only state where the value of the services provided by hospitals has been questioned. In a brief filed before the Vermont Supreme Court to recover property taxes from the nonprofit Medical Center of Vermont, the City of Burlington told the Court:

> MCHV [Medical Center Hospital of Vermont] claimed to have provided $1.4 million in free care throughout its entire service area which includes upstate New York, and it claimed to have provided $720,000 in free care to residents of Burlington in fiscal year 1986. . . . In exchange for this claimed "charity care" MCHV seeks to continue enjoyment of a tax exemption worth twice as much - $2.8 million annually. . . . Burlington would be better off to receive tax payments from MCHV, reserve a certain portion of the proceeds into a fund to cover the cost of care to its uninsured and indigent citizens, and apply the balance toward deferring the considerable cost of supplying municipal services to MCHV.

The tax subsidy measured here is only the local property tax for services which the city must continue to provide the hospital. The cost of providing these services must be paid for by the rest of the local community. In addition, the nonprofit hospital receives other subsidies such as exemption from state and Federal income taxes, and the cost of these unpaid or exempt taxes is borne by the state and Federal taxpayers.

Measuring the "Social Burden" of Hospitals

As reported in the May 5, 1988 edition of the Washington Post, a study (conducted by Lewin & Associates for the Volunteer Trustees of Not-for-Profit Hospitals) published in the New England Journal of Medicine contends that:

> Nonprofit hospitals provide "substantially more" free care than for-profit ones, despite surveys suggesting that little difference exits.

In a May 16, 1988 U.S. News & World Report article, "Putting money ahead of mission?" the author, Susan Dentzer, referring to this same study published in the New England Journal of Medicine, writes:

> But focusing on charity care is a mistake, most health economists assert. For one thing, hospital accounting is messy: It's tough to determine how much free care hospitals give away purposefully and how much is really "bad debt" – hospital bills that were never paid.

The Coalition maintains that bad debt should not be equated with charity care. Charity involves the spirit of giving, expecting nothing in return. Bad debt involves giving up on someone who has been billed, dunned, and squeezed without getting payment. There is no charity in bad debt. Further, as pointed out by an article in the July, 1988 Virginia Business, "Metastasis," the article in the New England Journal of Medicine does not take into account the tax-exempt status of the nonprofits. The authors, James A. Bacon and James Schultz, write:

> The article, which appeared in the prestigious New England Journal of Medicine, also neglected to examine the effect of taxes. When VIRGINIA BUSINESS combined taxes and uncompensated care to arrive at a total "social burden," it found that investor-owned hospitals hefted a heavier load: 10.6 percent of revenues compared to 7.1 percent for the not-for-profits.

The Virginia Business article measured the "social burden of Virginia hospitals" by combining the percentage of bad debt and charity care and the percentage of taxes paid as a percentage of 1986 revenue.

The for-profits' percentage of charity care and bad debt was 3.6% of revenue, and taxes comprised 7% of revenue for a combined total social burden of 10.6%.

The nonprofits' percentage of charity care and bad debt was 7.1% of revenue and taxes were .02% of revenue for a combined total social burden of 7.12%.

Using this measurement, the for-profits in Virginia contribute 3.48% more of their revenues to the community than do the nonprofits.

A PROFIT IS NOT A PROFIT

When is a profit not a profit?

Webster's New World Dictionary (1984, Simon and Schuster) describes a profit as "the sum remaining after all costs, direct or indirect, are deducted from the income of a business." And, alternately, "a) financial or monetary gain obtained from the use of capital in a transaction or series of transactions b) the ratio of this to the amount of capital invested."

When nonprofit hospitals have an excess of income over expenses this is called a "surplus," not a profit. A representative of the nonprofit community, Mathew Ahmann, (Chairman, Independent Sector Task Force on the Unrelated Business Income Tax), told the U.S. House Small Business Committee on June 29, 1988:

> Nonprofit organizations do not have "profits" in the same sense that private businesses do. . . . By contrast, if a nonprofit has an excess of revenue over expenses, a relatively rare occurrence, the surplus must be used for the charitable purposes of the organization. (Page 7.)

While Mathew Ahmann says they "must" use surpluses for "charitable purposes," in fact, they don't. We find that "surpluses" are used to invest in new business ventures.

Furthermore, the surpluses of many of the nonprofits are considerable. Virginia Business (February, 1987) reported that 32 out of 50 of Virginia's most profitable hospitals are nonprofits. The profits of the nonprofitsranged from 7.1% to 18.6%. As one hospital executive was quoted in the article:

> There's been a long debate over how much profit a not-for-profit hospital should make. But most of us would say 18.6 percent is more than enough . . . I almost feel embarrassed about it . . .

In a study titled "Hospital Care for the Poor in Southeastern Pennsylvania 1985" published by the Center for Health Services research of Southeastern Pennsylvania, 1986, concludes:

> Hospitals in Southeastern Pennsylvania provided a significant amount of uncompensated care in 1985. However, the financial resources available to the hospitals were also significant. Hospitals earned over $145 million after the provision of $111 million in charity care. An additional sum of at least $67 million in nonoperating revenue was also available, producing a "bottom line" profit of at least $213 million. In the aggregate, hospitals were not negatively impacted by charity care, and, in fact, could have provided a great deal more care for the poor without compromising their financial positions. (Page 12.)

In California, for the reporting period of 6/30/85 through 6/29/86 the profitability ratio for net return on operating assets (profits) for 497 reporting hospitals, including public, nonprofit and for-profit, was 7.31%.

Looking at some of nonprofit hospitals in this area of California, the West Bay, profitability ratios for net return on operating assets were:

Presbyterian Hospital of Pacific Medical Center	+12.86%
St. Francis Hospital	+19.13%
Seton Medical Center	+12.08%
Mills Memorial Hospital	+10.59%
Peninsula Hospital and Medical Center	+24.01%*

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* Statistics are from Individual Hospital Financial Data For California, Report Periods Ending June 30, 1985 - June 29, 1986, Office of Statewide Health Planning and Development.

In other areas of the state, profitability ratios for net return on operating assets for the following nonprofits were:

Mercy Medical Center -- Redding	+22.91%
Fremont Hospital Hospital	+23.35%
Rideout Memorial Hospital	+29.25%
Mercy San Juan Hospital	+21.80%
Sutter Memorial Hospital	+25.09%
Tracy Community Memorial Hospital	+21.21%
Stanford University Hospital	+22.40%
Good Samaritan Hospital of Santa Clara	+20.32%
Monte Villa Hospital	+31.00%*

For this same time period profitability ratios for net return on operating assets by type of control of hospital in California were:

City/County	-42.73%
District	+ 8.29%
Investor-Owned	+19.71%
Nonprofit	+ 9.55%**

As demonstrated earlier in the article by Pattison, there is no substantial difference in the type of patient served by the various groups of hospitals in California, nor in the amount of charity care given. The investor-owned hospital additionally pays taxes -- income, property, and sales. Using the Virginia model of social burden carried by different groups of hospitals, the investor-owned hospitals carry a greater social burden, that is, contribute more to society than the nonprofits. Finally, the profitability ratios of the California nonprofit hospitals are healthier than most small businesses in the state.

The 532 California hospitals reporting statistics had a net income from operations of $403,205,184. When non-operating revenue was added, these hospitals had a net income of $1,063,630,433.

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* Statistics are from Individual Hospital Financial Data For California, Report Periods Ending June 30, 1985 - June 29, 1986, Office of Statewide Health Planning and Development.

**Statistics are from The Aggregate Hospital Financial Data for California, Report Periods Ending June 30, 1985 - June 29, 1986, Office of Statewide Health Planning and Development.

A net income of $1,063,630,433 is mind-boggling for most small businesspeople who might have competition from one of these hospitals. Looking at some individual hospitals in the Bay area paints a very profitable financial picture:

Hospital	Net Income from Operations	Net Income (Profits)
Mt. Zion Hospital and Medical Center	$2,206,436	$4,391,151
Presbyterian Hospital of Pac Med Ctr.	$7,850,504	10,066,957
Ralph K. Davies Medical Center	$2,041,726	$2,422,307
St. Francis Memorial Hospital	$5,066,019	$7,134,982
St. Mary's Hospital and Medical Center	$7,536,768	$8,314,312
University of California Hospitals and Clinics	$5,883,740	$6,784,986*

The considerable revenue at the disposal of nonprofit hospitals allows them to enhance their facilities (they need not worry about paying dividends to stockholders). This considerable revenue at their disposal also gives them start-up capital with which to start many small businesses ventures without the risk that the small businessperson takes when he or she borrows money from a bank. The absence of risk is a key factor in encouraging nonprofit hospitals to invest in business subsidiaries.

NONPROFIT HOSPITALS -- NEW BUSINESS VENTURES

One of the ways in which hospitals have changed is by restructuring corporate control. The Pennsylvania study previously cited ("Hospital Care for the Poor in Southeastern Pennsylvania 1985") points out that:

> ... a number of hospitals have completed corporate restructurings which had the effect of transferring income-producing assets to related

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* Statistics are from Individual Hospital Financial Data For California, Report Periods Ending June 30, 1985 - June 29, 1986, Office of Statewide Health Planning and Development.

corporations. In these instances, nonoperating revenue will not be as high as it would have been before restructuring, thus producing an understatement of resources available to finance uncompensated care. Therefore, to obtain a true picture of a hospital's ability to provide charity care, a consolidated balance sheet and statement of operations should be publicly available. (Page 12.)

When hospitals restructure -- creating nonprofit and for-profit subsidiaries -- it is impossible to know the true "surplus" or profit of the nonprofit that restructures itself. Each separate non-profit entity files its own 990 or 990-T with the IRS as they are required by law. What if a hospital has ten or more separate subsidiaries and joint ventures? There is no aggregate accounting of their activities to the public. To get a true financial picture of a restructured nonprofit hospital would require skillfull detective work. Sales and profit information on hospital subsidiaries is often hidden from the public.

In Fairfax County, Virginia, the Fairfax Hospital Association created an umbrella corporation to give it more flexibility in launching profit-oriented business ventures. Now known as Inova Health Systems, the hospital board is today free to launch new businesses. For example, they now have a division known as "Health Enterprises," which according the the Fairfax Journal, has "responsibility for taxable, profit-motivated ventures." They are going into the nursing home business. They have invested three million dollars in what they call "venture capital." They own a durable medical equipment company anda bill collection agency. Their equipment repair company fixes medical equipment for 40 hospitals on the East Coast.

Corporate restructuring allows for the creation of a non-profit umbrella corporation. In total, this nonprofit umbrella corporation owns four not-for-profit hospitals, 12 for-profit businesses, and 10 not-for-profit businesses. According to the statement by Fairfax officials, their profitability is so good that they will soon pay off all their development costs. For-profit sales totaled $22 million and from that amount, they had a profit of $1.9 million.

Such commerciality is not limited to a few hospitals in a few states. The Washington Post, in a February 15, 1987 article titled "Nonprofit Hospitals Venture Into New Lines of Business," reports:

> Increasingly the nation's 3,500 private, nonprofit hospitals have started or are considering diversifying into commercial services. They are diversifying not only for new sources on income but also to attract doctors and patients.

In Nashville, Tennessee, the Metro Tax Assessor, who had been in the job for 11 years was quoted in the Nashville Banner (January 1, 1987) as saying:

I was not really aware of the profits made by these facilities that enjoyed exemption from property taxes for the services they receive. I was not aware how lucrative it is.

The network of businesses and joint ventures set up by these hospital corporations is so complicated that most people do not realize that their nonprofit hospital is involved in all these business ventures.

In California, Timothy W. Waits, President of the John Davis Company told the A.B. 944 Advisory Task Force on Competition Between Nonprofit Organizations and Small Business that there are two reasons for hospital restructuring:

> . . . non-profit hospitals across the country initiated complex structural reorganizations in an attempt to remove certain types of activities and incomes from direct scrutiny. The structural changes characteristically have a non-profit holding company or foundation owning a multi-layered group of entities; some of which are for-profit and others are not-for-profit. The point to be made here is that the Internal Revenue Code allows for the integration under common ownership both of for-profit and not-for-profit entities. With this legal structure, defining non-related business income or activities for the whole organization becomes a very difficult task.

Thus by corporate restructuring hospitals accomplish two goals. The nonprofit hospitals:

- Avoid complete disclosure of all subsidiary activities.
- Make it impossible for the IRS to aggregate the amount of income tax or Unrelated Business Income Tax owed because under the present law each affiliate files separate returns.

Neither goal is in the best interests of the public.

Albert L. Spitzer of the Department of the Treasury told the U.S. House Committee on Small Business (June 28, 1988):

> . . . many exempt organizations operate unrelated businesses in taxable subsidiaries that file corporate income tax returns. Under current reporting requirements, it is not possible to identify the returns of taxable corporations owned by exempt organizations or to correlate such returns with those of their parents.

If the Treasury can't figure out how much these hospitals owe in taxes, no one can.

One of the advantages to the nonprofits of such a reporting system is that it is impossible to determine the amount of commercial activities of the nonprofit. A nonprofit found to be engaged in a substantial amount of unrelated business could lose its tax-exempt status.

Sister Bernice Coreil of the Catholic Health Association admitted to the House Ways and Means Subcommittee on Oversight:

> Through the creation of for-profit subsidiaries, which pay taxes on their net income before the after-tax income goes to the not-for-profit hospital, we have been able to integrate into our total health care system certain services in which we otherwise would be unable to participate. This is because the amount of unrelated income from these services within the tax-exempt hospital could have jeopardized our tax exemption by possibly exceeding an "insubstantial" amount of our total income. (Hearings, Serial 100-27, page 915.)

The bottom line of what Sister Coreil is saying is that nonprofit hospitals make a lot of profit from their business venture, but use the tax laws to protect the nonprofit "charity" status of the hospital itself.

The combination of lack of enforcement of the UBIT because of the difficulty in administering this section of the tax code and the inability to determine the full extent of a nonprofit's commercial activity creates a situation which encourages the nonprofits to diversify as much as they want with virtual impunity.

STATE LEGISLATURES REQUIRING MORE HOSPITAL DATA

Where are the guidelines for these financial dealings, which are pitting the not-for-profit hospitals into head-to-head battles with for-profit small companies? What assures that you and I as patients are not overpaying our hospital costs to the tune of 7.1% to 18.6% or more to help finance risky business ventures by hospital management? What is there to assure arms length dealings between hospitals and their for-profit ventures? What ensures that taxable income won't be shielded by administrative spending? When hospitals make profits, why don't they share some of the money with patients instead of reinvesting it in new business ventures?

One of the problems encountered by legislators, both on the national and state levels, is lack of data on the commercial activities of the nonprofits. Some states are trying to remedy this situation. As mentioned earlier, we know more about hospitals than any other sector of the nonprofit community. And the more we learn, the more convinced we are that nonprofit hospitals have unfair advantages in the commercial market place.

Virginia legislators, concerned with the growing commercial activities of hospitals and the affect of these activities on the delivery of health care, passed a law (Sec. 9-160 of Chapter 26 of Title 9) to get a handle on the extent of these activities. Hospitals and corporations that control hospitals must report all their affiliates along with the tax status of each affiliate, total assets and revenues, net profits or surpluses (for the nonprofits), and the net equity or fund balance (for the nonprofit). In addition each hospital or hospital controlling corporation must also report its total assets, revenues, net profit (if for-profit) or its excess revenues (if nonprofit) and net equity of a for-profit or the fund balance of a nonprofit. The Coalition supported the passage of this law.

In Pennsylvania, Representative Italo Cappabianca (D - 2 Erie) has introduced legislation to establish a data base on the activities of the nonprofits. This bill requires the reporting of affiliates of nonprofits. It requires the Department of Revenue to determine the level of commercial activity of nonprofit corporations and their affiliates, and the fiscal impact of the commercial activities of the nonprofits on the Commonwealth of Pennsylvania. We support this legislation.

While the Virginia law applies only to hospitals, the Pennsylvania proposal, if passed, would apply to all nonprofit corporations.

The "HALO" EFFECT

One of most awsome advantages nonprofits have is the "halo" effect. Most people, upon learning that one business is nonprofit, automatically assume, because it is nonprofit, that the business is not out to make money. The nonprofit is thus assumed to be more trustworthy because of its nonprofit status. Further, the nonprofit's name often invokes an appearance of trust that no small business can achieve.

In his testimony before the A.B. 944 Advisory Task Force on Competition Between Nonprofit Organizations and Small Business, on June 24, 1988, William F. Sandbach, Executive Director of the Hearing Aid Association of California, described the "halo" effect:

> It gives non-profits, in addition to the financial edge they already enjoy, the ability to capitalize on the perception that because they are non-profit, they are the "good guys," sell at lower prices, and have no incentive to sell at all.

Sandbach goes on to say that the nonprofits are fully aware of the "halo" effect and "how to use it." The June, 1988 Newsletter of the Norcal Center on Deafness (which has branches in Sacramento, Stockton, South Sacramento, Yuba City, and Modesto) describes its services:

> . . . and since the clinic is nonprofit, prices are reasonable. Best of all, the people in the clinic care about the people they serve.

The "implication," of this statement, according to Sandbach is that "anyone in business to make a profit doesn't" [care about the people they serve].

HOSPITAL MONOPOLY STEERS PATIENTS TO CAPTIVE BUSINESSES

This "halo" effect carries over into referring hospital patients to services provided by the hospital that are also available in the private market. Known as "captive referral," nonprofits steer patients only to services owned by the nonprofit hospital. Many patients automatically go to the business recommended by the hospital not knowing, in many cases, that there are other sources in the community for the same services or products and in some instances at a lower price.

Timothy W. Waits of the John Davis Co. in Sacramento, California which supplies home medical equipment explained the problem to the AB 944 Task Force in California:

> The hospitals then instruct their Discharge Planners to refer patients only to the hospital owned subsidiary company. The practice known as "captive referral" is widely practiced and disadvantages the patient in serveral ways. First, since the patient has no effective method of comparison shopping, the patient may pay more for products than he or she would in an open market atmosphere. Secondly, the patient will often receive poor quality equipment or less than adequate service from a company that knows they are going to get all the business and do not have to compete for it.
>
> The small business provider of Home Medical Equipment is disadvantaged by these captive referral practices in that he has no way of effectively competing with the hospital owned subsidiary corporation. (Page 1.)

This past year the Virginia Legislature passed a law which now requires hospitals to inform patients that the service or equipment may be available at other businesses in the community.

The previously mentioned Harvard report (Harvard Business Review, "Who Profits From Nonprofits?" January-February, 1987, by Regina E. Herzlinger and William S. Krasker) also alludes to this "halo" effect. One of the assumptions made about nonprofit corporations is that:

> . . . nonprofit managers operate from a moral base that makes them more trustworthy than for-profit managers because the mission of their organization is not to make money but to serve society. (Page 94.)

However, it goes on to say:

> Given the weaker controls on nonprofits, however, it is unclear why nonprofit managers should not be equally likely to direct such funds into

> larger salaries, organizational perquisites, and excessively large staffs. (Page 94.)

And indeed this is what the city of Burlington charges in its lawsuit against the Medical Center Hospital of Vermont. In the course of the suit it was revealed:

> MCHV President's salary jumped 192% from 1981 to 1986. The largest percentage increase - 25% - came in 1986, the year immediately following MCHV's record 8.23% net operating income in 1985. By contrast, average employees received a 5% increase. The 1985 lowest pay increase for top MCHV executives was 4.6% (inflation adjusted) following the 1984 fiscal year when MCHV reported a 1.09% loss to the IRS. (Vermont Supreme Court Docket No. 87-501, Appellant's Brief, p. 26.)

Salaries for top executives are profit-driven just as in the for-profit sector. The more money a nonprofit earns the more it can disburse to its top executives. Is this in the public interest?

Further, the article, "Profits and Health Care: An Introduction to the Issues," published in For-Profit Enterprise in Health Care (Institute of Medicine, National Academy Press, 1986.) asserts that:

> . . . even the not-for-profit's prohibition against distribution of profits has begun to break down as legal ways are discovered whereby not-for-profit organizations can develop incentive compensation arrangements for management and staff that are essentially profit-sharing plans. (page 10.)

The "halo" of the nonprofit hospital is tarnished by excessive executive salary compensation. But the public is unaware of this fact or of the profit-driven motives of nonprofits.

LACK OF ACCOUNTABILITY OF THE NONPROFITS

One of the problems addressed by the previously mentioned Harvard study (Harvard Business Review, "Who Profits From Nonprofits?" January-February, 1987, by Regina E. Herzlinger and William S. Krasker) is accountability:

> But nonprofits are not the same as public organizations because they have few outside controls on their activities. The free market sector is watchdogged by everything from the stock market to government regulatory agencies and consumer advocate organizations. Government institutions have somewhat fewer controls on their performance, like the voting process and bureaucratic budgetary control. Nonprofits have even fewer; boards of trustees appoint their managers who are then subjected to little outside scrutiny. Although some observers believe donors act as a control, in reality they are hardly involved with the impact or results of their donations. (Page 94.)

Testifying before the House Ways and Means Subcommittee on Oversight, O. Donaldson Chapoton, Deputy Assistant Secretary of the Department of the Treasury, told the Subcommittee of the Department's concern with the accountability of the nonprofits:

> In considering how tax-exempt organizations function, one question that is raised, both in the IRS review of these matters . . . is the accountability of tax-exempt organizations to someone.
>
> I think currently the concept of accountability is really determined primarily by the IRS examinations of the tax-exempt function, if they are earning unrelated business income, and if they are, is this business income being properly reported and taxed.
>
> I have some concern, though, whether that is a sufficient analysis, or a sufficient determination of the accountability of tax-exempt organizations . . . (Hearings, Serial 100-26, Page 14.)

Another Treasury official, Adelbert L. Spitzer, told the U.S. House Small Business Committee:

> Because nonprofit organizations are privately controlled, however, their activities are not subject to the public review or scrutiny that applies to the actions of government. (June 28, 1988, page 15.)

IRS Commissioner Lawrence B. Gibbs testified that his organization reviewed only 5% of the total exempt forms filed. (Hearings, Serial 100-26, Page 70). So, very few nonprofit tax returns are looked into.

The Coalition does not believe this is an adequate safeguard for the amount of public money that the nonprofits control. In addition, the IRS only looks to see that the nonprofit is performing its tax exempt function. And as Adelbert L. Spitzer of the Treasury told the House Small Business Committee (June 28, 1988, page 16):

> . . . the role of determining whether contributed funds are used wisely and efficiently is not a function of the tax law, but is performed to some degree by donors who support exempt organizations.

Jack W. Owen, Executive Vice President of the American Hospital Association, tried to maintain that nonprofit hospitals are accountable. In a letter to the U.S. House Ways and Means Subcommittee on Oversight he wrote:

> Accountability is an important factor in determining the continued integrity of tax-exempt status. However, the Treasury Department's concern with this issue is not applicable with respect to the hospital industry. Although privately controlled, not-for-profit hospitals are scrutinized carefully in the delivery of health care services, and

> disclose considerable information about their operations. (Hearings, Serial 100 - 27, page 975)

But the Coalition finds that many public boards of nonprofit hospitals devote themselves to issues of fundraising and services and pay little attention to the business ventures launched as subsidiaries and joint ventures with hospital funds.

Just how difficult it is for a private citizen to obtain meaningful data on nonprofits can be appreciated from the testimony of Thomas M. Asher, Ph.D. (Chairman, HemaCare Corporation, Sherman Oaks, California) before the AB944 Task Force. After detailing the activities of Red Cross and other tax-exempt blood collection centers in California, Asher says:

> It has been impossible for me or the public to obtain meaningful financial statements from the centers and many, if not all, of my suppositions are undocumented. While audits have been performed, they appear superficial and without the purpose of clearly identifying costs.
>
> While the 13 non-Red Cross centers are required to file annual financial statements with the Registry of Charitable Trust, my examination of some of these shows them to be superficial, incomplete, and chronically tardy in submission. The American Red Cross was exempted from filing such statements by a private ruling of the California Attorney General in 1962, and only their edited "summaries" are available to the public. Personal phone calls to all 15 centers requesting financial reports and fee schedules resulted in a blatant denial to provide any financial information . . . by 5 of the centers. A handful of the 15 sent descriptive brochures devoid of any financial information.

For the private citizen it is almost impossible to obtain information to document unfair business practices because of the unavailability of information.

And while Merlin K. DuVal, President of the American Healthcare Institute (a national network of 31 voluntary not-for-profit hospitals) told the U.S. House Ways and Means Subcommittee on Oversight that these nonprofit hospitals are "publicly accountable and locally controlled," (Hearings, Serial 100-27, page 931), William J. Lehrfeld, Counsel for the Shriners Hospitals for Crippled Children, had another opinion. He told this same Subcommittee that "the public has only apparent and not real access to information about the finances of exempt organizations." (Hearings, Serial 100-27, page 944.) Further, he told the Subcommittee that:

> . . . part of the nonprofit sector's problems are of their own making by failing to be, or even appear to be, accountable to the public which so generously supports them through the federal tax laws. A complete revision of the reporting and disclosure rules is in order now, with

special emphasis on all large exempt organizations, including religious societies. (Hearings, Serial 100-27, page 938.)

We thoroughly agree with Lehrfeld and support legislation to completely reform the system of reporing and disclosing nonprofit data.

As pointed out previously with the complicated corporate restructuring, it is impossible for the IRS to determine the full extent of a nonprofit's subsidiary activities, both nonprofit and for-profit. And in the case of the private nonprofit, the average citizen has even less access to ascertain how funds are being used.

Though hospitals are required to report more information than many other nonprofits, the reporting laws are not adequate enough to ensure that disclosure is complete and understandable to the general public.

CONCLUSION

The commercial nonprofit hospital which relies little on donations, gives little charity care, channels millions of net income dollars into business ventures, frustrates public scrutiny with a network of subsidiaries and joint ventures, and concentrates largely on mounting profits is the dinosaur of the health care industry and its tax-exempt status should be in jeopardy. The conditions under which the private nonprofit came into existence have changed dramatically over the years. Today these hospitals are essentially charging fees for all services rendered and provide as much charity care and community service as do their for-profit counterparts.

Most nonprofits are as profit-driven as the for-profit hospital. Society should no longer provide an artificial atmosphere of tax subsidies to profit-seeking hospitals which have forsaken the god of charity for the god of profits.

Nonprofits produce profits. It is time the public is told that nonprofits syphon off profits from patient fees to subsidize risky business ventures. It is time they competed in the marketplace like any other for-profit: if they act like for-profit businesses, they should be taxed like for-profits. The commercial nonprofit dinosaur should take its place in corporate life where it belongs.

The Utah Decision

The Coalition agrees with the Utah Supreme Court and the people of Utah. The Utah Supreme Court ruled (June 26, 1985) that hospitals are entitled to tax breaks only if they meet stringent charity guideline. The citizens of Utah narrowly defeated a proposition that would have protected hospitals from property taxes if they document ample charity care. With Utah Supreme Court saying essentially the same thing, the citizens of Utah saw no need to shield nonprofit hospitals from property taxes via their constitution.

The Utah Supreme Court wrote:

> ... A hospital, whether not profit or for profit, that provides its services to paying patients relieves no public burden because in its absence, the government would not [or would have no duty to] provide free health care to patients able to pay for treatment ... If not-for-profit hospitals which charge fully for their services, were to be made tax exempt under the corporate burden theory, for-profit hospitals logically ought to be treated in the same manner since both provide the public with the same service. Indeed, it might be argued that for-profit hospitals relieve a greater portion of the public "burden" because they provide medical care without public subsidy. All hospitals use tax supported public services. including road construction and maintenance, police protection, fire protection, water and sewer maintenance, and waste removal, to name a few. Exempt hospitals use those services at the expense of not exempt health care providers and other taxpayers, commercial and individual ... (Intermountain Health Care, supra at 277-278.

Hospitals which provide charity care, which contribute to the community more than they are provided in tax-exemptions should retain those tax preferences. Hospitals that show profit margins and diversify to increase their income should be treated just like any other business.

No Reason to Subsidize Commercial Nonprofits

Henry Hansmann, professor at Yale Law School, told the House Ways and Means Subcommittee on Oversight:

> ... The more important issue, and the one that is becoming increasingly difficult to avoid, is the appropriate scope for the basic section 501(c) exemption itself.
>
> I believe that it is time to think harder about the classes of non-profit organizations that should qualify for this exemption. The most troublesome classes of nonprofits from this perspective are the so-called commercial nonprofits. These are nonprofits that derive substantially all of their income simply from the prices they charge for the goods and services they produce, and receive no meaningful amount of donative support. For example, today most nonprofit hospitals, nursing homes, health-maintenance organizations, day-care centers, and summer camps would probably fall within the category of commercial nonprofits. (Hearings, Serial 100-28, p. 1833.)

"While there is no reason to drive the nonprofits out of such industries today," Hansmann also says that there is no reason "to subsidize them." (Hearings, Serial 100-28, page 1833.)

Congress and the legislatures may soon need to withdraw or sharply constrict the tax preferred treatment of the most commercial of the nonprofits. They produce profits and enter into competition with for-profit companies. They often do not provide charity equal to the taxes they are exempted from. They have invaded markets previously served by private small businesses. They enjoy a special market halo in the eyes of the public. They control who their patients buy from when leaving the hospital. The net result of changes advocated by the Coalition will be a health care system that is sensitive to the realities of the marketplace and is fair to the public and to the business community.

I want to thank the National Hearing Aid Society for inviting me to speak before your 1988 convention. On behalf of the Business Coalition for Fair Competition I would like to extend our appreciation to the National Hearing Aid Society for the outstanding contributions you make to our joint search for a solution to the problem of unfair competition. I look forward to continuing our working relationship with Jim Lovell and with your newly elected president, Robin Holm. Over the years we have found many friends and supporters in the Society and I look forward to working with all of you who are old friends and making new friends in your fine organization.

Business Coalition For
FAIR COMPETITION

MEMBERS OF BUSINESS COALITION FOR FAIR COMPETITION

American Association of Nurserymen
American Association of Small Research Companies
American Blood Resources Association
American Consulting Engineers
American Council of Independent Laboratories
American Orthotic & Prosthetic Association
American Society of Travel Agents
American Veterinary Medical Association
Arizona Search Consultant Association
Association of Data Processing Service Organizations
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Asssociation of Physical Fitness Centers
Business & Associations for a Strong Economy
Health Industry Distributors Association
Information Industry Association
International Communications Industries Association
International Racquet Sports Association
National Association of Chain Drug Stores
National Association of Medical Equipment Suppliers
National Association of Retail Druggists
National Federation of Independent Business
National Hearing Aid Society
National Office Products Association
National Tour Association
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Small Business Legislative Council
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U.S. Chamber of Commerce

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3017:00:6108:1fm

July 15, 1988

The Honorable John J. LaFalce
Chairman
Committee on Small Business
U.S. House of Representatives
2361 Rayburn House Office Building
Washington, D.C. 20515

Dear Mr. Chairman:

Near the conclusion of the Committee's June 29 hearing into allegations of "unfair" competition between the for-profit and nonprofit sectors, Representative Hefley made the following statement:

> ". . . I am still besieged by constituents that complain because Goodwill has opened an upholstery shop in competition with the small upholsters in the community, a shop not designed to train handicapped people to upholster, but a shop which actually competes for experienced upholsters to come in and do the job in order to make money for Goodwill, so that they can use that money then to service handicapped people."

We have met with Representative Hefley to discuss the operations of Goodwill Industries of Colorado Springs, Inc., an autonomous, tax-exempt community-based organization which is a member of Goodwill Industries of America, Inc. (GIA). To clarify the hearing record, the vocational rehabilitation program to which Representative Hefley referred (actually, furniture refinishing rather than upholstery work) currently employs nine individuals with disabilities, six of whom are classified as "severely disabled" with inconsequential productive capacity. These individuals earn wages of $2.38 to $3.35 per hour based on their individual productivity under the special minimum wage provisions of the Fair Labor Standards Act. The severity of these individuals' disabilities necessitates a high employee -- supervisor ratio, with eight supervisors (six with disabilities) currently employed.

Since the program's inception in October, 1986, 34 individuals with disabilities have received vocational rehabilitation and job-training services, and 13 have become competitively employed as a direct result.

In addition, Representative Hefley's statement concerning Goodwill's competition for "experienced upholsters" is not supported by the facts. To our knowledge, only one individual formerly employed by a for-profit furniture refinishing business in the Colorado Springs area is now employed by Goodwill in a supervisory position. However, this individual came to Goodwill only after his (for-profit) employer asked Goodwill to hire him because he was going to be laid off. To infer that Goodwill "hires away" experienced employees from for-profit entities to support their refinishing program is misleading.

We have provided the Committee staff with a copy of GIA's analysis of the "unfair" competition issue, Evaluating the Issue of Alleged Unfair Business Competition Between Goodwill Industries and the For-Profit Commercial Sector. The conclusions reached in this quantitative economic study reveal that competition does exist between Goodwill and for-profit entities in certain markets. It is critical to note, however, that this competition cannot be construed as "unfair" because of the inherent, self-imposed labor inefficiencies accepted by Goodwill. In the Colorado Springs Goodwill example, you will note that the employee -- supervisor ratio is nearly one-to-one due to the nature of Goodwill's workforce, individuals with disabilities. This ratio is substantially higher than would occur in a for-profit business, and results in considerably increased labor costs. Goodwill also seeks to maximize employee turnover, as evidenced by the number of individuals with disabilities placed into competitive employment following their training and acquisition of other vocational skills. For-profit businesses attempt to retain their trained employees in order to minimize labor costs.

Finally, GIA's analysis concludes that vocational rehabilitation activities such as those undertaken by the Colorado Springs Goodwill are clearly in the national interest and make substantial contributions to the public good. These contributions include reductions in federal and state benefit payments and increased tax revenues generated when Goodwill takes an unemployed individual with disabilities and provides them with the necessary vocational skills to become employed. The for-profit sector, including small businesses, is a direct beneficiary of Goodwill's activities: Employee training costs are substantially reduced when Goodwill is utilized by for-profit entities as a reliable source of trained workers available to enter the workforce.

The hearings before the Committee on Small Business demonstrated the complexity of this issue and we strongly urge the Committee to proceed cautiously in formulating any recommendations. We do not believe changes in federal law affecting the tax-exempt status and operations of organizations such as Goodwill Industries are justified. We recognize, however, that the limited number of complaints from the for-profit sector directed at Goodwill Industries often result from a lack of clear understanding of

Goodwill's mission and purpose, or from misleading or incomplete information presented to Members of Congress. These misunderstandings are best resolved, we assert, at the local community level rather than by federal legislation that would restrict Goodwill's ability to continue to provide vocational rehabilitation services and employment to individuals with disabilities.

Again, we appreciate this opportunity to clarify the hearing record, and look forward to working closely with you and your staff in examining these allegations of "unfair" competition.

Sincerely,

David M. Cooney
Rear Admiral, USN (Ret.)
President & Chief Executive Officer

cc: Goodwill Industries of
Colorado Springs, Inc.

IRSA

132 Brookline Avenue • Boston, Massachusetts 02215 • 617 / 236-1500

July 18, 1988

The Honorable John J. LaFalce
Chairman, Committee on Small Business
2361 Rayburn House Office Building
Washington, D.C. 20515-6315

Dear Chairman LaFalce:

On behalf of the International Racquet Sports Association (IRSA), a national trade association representing over 1400 tax-paying, small business, athletic, fitness and racquet centers, I am writing regarding your hearings conducted on June 28-29, 1988 into the area of unfair competition between tax-paying, small businesses and tax-exempt organizations.

IRSA has testified previously during the hearings conducted by the Subcommittee on Oversight of the House Ways and Means Committee on this same issue. We noted that as of 1987, 94 percent of our clubs are in direct competition for members with tax-exempt YMCAs. During this past decade, the health club industry has witnessed the progressive commercialization of Y facilities as they have sought to position themselves at the center of the upscale fitness market, in both affluent suburbs and downtown business and professional centers.

The new Y health facilities resemble commercial fitness centers in virtually every respect: pricing structure, advertising policies, and investment record. A recent IRSA survey of market rate Y membership prices shows that YMCAs charge from 30 to 50 dollars a month and attract the same socio-economic market segment as comparable commercial clubs. Y advertisements are no different, in content and format, from those of commercial clubs. Finally, across the country, YMCAs have abandoned facilities built to serve the homeless and disadvantaged and opened new facilities to provide for the athletic and fitness needs of professional men and women. It is clear that YMCAs are engaged in business activities identical to those carried on by IRSA's members. In fact, from the consumer's perspective, there is no discernable difference in membership in a Y and membership in a private health club. Too often, an existing YMCA serves as a barrier to tax-paying fitness centers that wish to enter a market area.

The fact that most YMCAs throughout the country have adopted in recent times a commercial, competitive operation stance in the recreation and fitness field, has been well documented in the transcript of the June 1987 hearings and by written submissions for the record. The commercial nature of YMCA operations has also been dramatically noted by State and County tax assessors (such as those in Portland, Oregon; Moline and Rock Island, Illinois, Olympia and Tacoma, Washington; Topeka, Kansas; and most recently, Pittsburgh Pennsylvania), where all or part of the facilities have been ordered returned to the property tax rolls (leading to current and past tax liabilities ranging from $430,000 to $1.2 million), and State tax exemption revoked.

Simply put, it is a question of how the issue is phrased. If the question in posed as "why are you performing this activity?" it gives rise to a broad response of noble purposes (e.g., contributing to the mental, physical and spiritual well-being of people) which is a universal mission. However, if the question is phrased "what are you doing? a much different response results -- providing a service or product for a fee (in direct commercial competition with other tax-paying, small business providers). In other words, what the Ys and (and JCCs and tax-exempt hospitals) are doing is a business with all that this encompasses -- marketing plans, advertising, initial extra benefits, fee scales, and ultimately profits, which, because of their tax-exempt status are put back into staff salaries and benefits (Ys tend to show a 56 percent payroll expense, which tax-paying clubs average a 30 percent payroll expense), facilities improvement, capital commercial expansion, and also, subsidies to other programs. However, long ago, Congress put to rest the "destination of income" test as a basis for exempting net revenues from taxation.

Thus, the clubs in our industry face a competitor that pays no Federal taxes. What compounds the problem is that this Federal exemption triggers many other advantages -- no property taxes, no state taxes, no county or municipal taxes, and no payroll insurance taxes. Moreover, Ys are allowed to market their facilities through lower postal rates, and by free public service advertising; they can receive tax-deductible donations from both the United Way and individuals; they are charged lower liability insurance rates; they can enlist a variety of voluntary labor and have privileged access to government grants. Finally, they can build and expand their facilities through tax-deductible donations, and out of the invested proceeds of previous tax-deductible contributions. In other words, it is estimated that the YMCA upgrade health and fitness centers have a 25 to 40 percent cost advantage over the tax-paying, small business, recreation and fitness centers with which they compete for members.

Recognizing that in many locales there is virtually no difference between upscale YMCAs and our members, the Assistant Secretary of the Treasury for Tax Policy recommended to the Subcommittee on Oversight on May 9, 1988 that the Ys be evaluated by the IRS on a facility by facility basis to determine if they are fulfilling a charitable purpose. Thereby, a determination could be made, not only if their recreational and fitness activity earning's were exempt from tax, but also if the facility itself could be termed tax-exempt.

Unfortunately, the current criteria for such an evaluation carried on by the IRS are drawn from GCM 39329, dated January 18, 1985, whereby provision of health related services for a representative group from the community suffices for a charitable determination. However, this creates a major loophole since the commercially competitives fees charged by the upscale Ys are affordable by a cross-section of the affluent communities in which they are located.

Rather, IRSA contends that in fairness, the charitable determination should be based on two, traditional and time-tested IRS criteria -

(1) to what extent they serve the so-called "charitable classes" (GCM 35601), (Rev. Rul. 75-109), the unemployed, disabled, handicapped, low-income senior citizens, underprivileged youth and military; and

(2) to what extent they are lessening the burden of government (Rev. Rul. 59-310) (so that if they ceased operating the centers, the government would have to step in and run it with public funds).

IRSA is also concerned that undue exemptions for royalty income could benefit the Ys, such as when there is the regular sale of athletic equipment, shoes, clothing, etc. with official logos on them, which would be tantamount to a lucrative partnership or mutual business venture which has nothing to do with the organization's stated mission.

In addition, care must be taken to preclude the Y's use of current reserves or investment principal and interest, resulting from past or future charitable contributions or donations, to fund additional, non-exempt, anticompetitive business ventures, e.g., the construction of more upgrade athletic clubs in downtown business or affluent suburban areas. For this purpose, we would recommend the establishment of the following regulation:

> Whenever a tax-exempt organization solicits or receives donations, contributions, etc., it must specify that none of the funds will be used for unrelated business activity and the donors should be so informed in writing. Should there be any violation of this, all sums should be returned to he donor immediately, with adjustments for tax penalties to make the donor whole.

IRSA also strongly supports that reasonable cost allocation procedures, similar to those utilized by the Medicare program, be utilized the YMCAs.

Finally, IRSA strongly urges the Subcommittee to adopt the recommendation of the Small Business Administration (SBA) that the IRS institute an expedited, administrative channel for the filing and review of complaints relating to the commercial activities of tax-exempt organizations. The protective spirit of UBIT and administrative efficiency of the IRS can be better served if the IRS has access to information targeting potential noncompliance with the law. Tax-paying small businesses are in the best position to identify potential violations of the law, but currently have no formal mechanism to do so.

Mr. Chairman, IRSA deeply appreciates your willingness both to explore the extent of unfair competition, and to pursue reasonable solutions whereby a fair market can prevail. We look forward to working with you, especially if you conduct further field hearings around the country.

Cordially,

John McCarthy

John McCarthy
Executive Director

OPENING STATEMENT

Presented by: Alan G. Schwartz, President
Tennis Corporation of America
2020 West Fullerton Avenue
Chicago, Illinois 60647

Subject: The Issue of Unfair, Tax-Exempt Competition

Mr. Chairman and members of the Committee, I appreciate the opportunity to testify on behalf of IRSA, The Association of Quality Clubs. My name is Alan Schwartz. I am a member of IRSA's Advisory Council, a past president of the National Tennis Association, and, for the past 19 years, President of TCA, which owns and operates racquet and fitness clubs throughout the U.S. IRSA is the national trade association for the tax-paying racquet, athletic and fitness club industry. The association currently has a membership of over 1,400.

The Issue of Unfair, Tax-Exempt Competition

In 1986, the White House Conference on Small Business found that unfair competition from tax-exempt businesses was the third most pressing issue for small businesses nationwide, just behind mandated benefits and the cost of property and casualty insurance. In the same year, the Government Accounting Office found that the racquet, athletic and fitness club industry was the industry most universally impacted by unfair competition from tax-exempt operations. Over 90 percent of IRSA clubs had tax-exempt operators taking business away from them in their primary market.

This year, the Department of the Treasury recommended to the Subcommittee on Oversight of the House Ways and Means Committee that the tax code be reformed so as to review the tax-exempt status of organizations on an industry-by-industry and facility-by-facility basis. We support the Treasury's recommendation.

Further, the Internal Revenue Service (IRS) has informed the Subcommittee on Oversight that the current provisions of the tax code regarding unrelated business income are not administerable. In our particular case, YMCAs define their tax-exempt purpose as universally as possible (to enhance the spiritual, intellectual, cultural and physical well-being of its members) so that virtually nothing is "unrelated."

IRSA's Position

We are not here to challenge all YMCAs. In fact, we enthusiastically support the work of those many, many YMCAs that continue in the tradition of their founders: serving youth of all nationalities, races and religions. We are here to say that there is a new type of Y and a new type of Y leader, who is building 8-, 10-, and 12-million dollar facilities in downtown business areas where there are no families and no children, and where there are already more private sector clubs than is required. They are also building in affluent suburban areas, already served by clubs from the private sector.

Is there, for example, any justification for the new $12 million Ketchum YMCA on the roof of the ARCO building in Los Angeles, surrounded on all sides by brilliant, new skyscrapers and the Westin-Bonaventura Hotel? Or the new $12 million YMCA in downtown Pittsburgh surrounded by the corporate headquarters of ALCOA, U.S. Steel, Pittsburgh Plate Glass and Mellon Bank?

The New YMCA

YMCAs are systematically disinvesting in poorer communities and reinvesting in affluent suburbs and downtown business and professional facilities. Examples of this can be found in Houston, Texas; Birmingham, Alabama; Portland, Oregon; Pittsburgh, Pennsylvania; Louisville, Kentucky; Los Angeles, California;

Marin County, California; Phoenix, Arizona; Baltimore, Maryland; Washington, DC; and elsewhere. Currently, the one new YMCA planned for Eastern Massachusetts is on the Waltham-Weston line. Weston is the highest per capita income area in Massachusetts and one of the highest in the country.

The YMCA is one of the most decentralized organizations in the U.S. Site selection, facility development, and fundraising decisions are all made at the local level with little or no recognition of the purpose or intent of the laws regarding tax exemption. As a result, dozens of the new gold-plated YMCAs neither lessen the burdens of government nor are they serving the so-called charitable classes. Almost all of these new facilities are being built in areas already served by commercial facilities rather than in less affluent areas that are truly in need of a YMCA.

Solon Cousins, Executive Director of the YMCA of the USA, increasingly aware that he cannot control local YMCA Boards of Directors intent on building YMCAs for business people, recently wrote a national appeal to all 2,200 YMCAs urging them to "Emphasize youth and family programming." In an effort for the Ys to avoid being taxed, he goes on and points out that, "Development of adults-only facilities by some YMCAs has been a major source of criticism in the tax challenge and significantly blurs the distinction between YMCAs and adult-oriented commercial health clubs." (From a letter dated February 29, 1988, and signed by Solon Cousins and Sam Evans, Chairman of the YMCA National Board.)

The Y Advantage

YMCAs have an average 32.4 percent cost advantage over commercial clubs, as in documented in Appendix A. Not included in the cost advantage just noted is that Ys receive a 50 percent reduced postal rate for bulk mailings (8.4¢ for Ys vs. 16.7¢ for clubs per 3.5 ounce piece). The reason that the Y enjoys this cost advantage is because it is classified as a public charity under section 501(c)(3) of the Internal Revenue Code.

In addition to receiving federal tax exemptions, the Y, by virtue of its charitable status, can enlist voluntary labor. Further, all contributors to the Y can claim tax deductions for their donations. It is these tax-deductible donations that are used to build and expand YMCA facilities.

It is this advantage that has and continues to seriously adversely impact the tax-paying racquet, athletic and fitness club industry. The Y advantage impacts the ability of existing tax-paying clubs to make a fair return on their investment (and in some cases to survive) and prevents would-be club entrepreneurs from building and/or expanding.

Court Decisions

In cases involving five YMCAs in four states, local tax authorities have placed the YMCA on the property tax roles:

** The Multnomah County YMCA in Portland, Oregon, was placed on the tax roles by the county tax assessor in 1985. Despite repeated appeals by the Y at local and state levels, the tax assessor's decision has been upheld.

** YMCAs in Rock Island and Moline, Illinois, were placed on the tax roles, in part, in 1983.

** The YMCA of Pittsburgh was placed on the tax roles, in part, this year, and similar treatment is being negotiated for the city's new $8 million Jewish Community Center.

** The YMCA of Topeka, Kansas, was placed on the tax roles last year. It was removed from the tax roles only after a state law was passed exempting from state taxation any organization that is exempt from paying federal taxes under

Section 501(c)(3) of the internal revenue code. Kansas is taking its lead from the federal government.

Conclusion

As the country becomes more and more aware of the needs of youth in our increasingly drug-infested culture, there has never been a greater need for authentic YMCAs. Why, we ask, should Ys want to build elite fitness centers for middle-aged business and professional clientele rather than serving the youth and poor of our country?

The YMCA is currently doing a disservice to the charitable community by diverting funds to serve the affluent. Last year, they absorbed millions of dollars of United Way contributions that could otherwise have been allocated to traditional charitable constituencies.

There is a profound difference between a public charity and a philanthropic organization. By law, a public charity must be organized exclusively for a charitable purpose or else it cannot claim title to tax exemptions. Further, the IRS has determined that ordinary recreational and physcial activities are not of themselves charitable activities.

Thus, for YMCAs to be legitimate public charities, their work must focus on serving the charitable classes such as youth, the poor, the disadvantaged, the elderly, etc.

In 1986, IRSA conducted its own survey of its member clubs and found that almost all of the nearly 300 respondents were involved in philanthropic charitable activity, making contributions ranging from $5,000 to over $100,000. Not one of these facilities is tax-exempt.

IRSA contends that many of the new YMCAs in affluent suburbia and corporate downtown are performing the same function and serving the same markets as tax-paying racquet and fitness clubs. Those Ys should be subject to the same taxes as commercial racquet and fitness clubs and those Ys should be forced to compete on a level playing field.

We urge the Committee to support the recommendation of the Department of Treasury that the tax code be reformed so as to review the tax-exempt status of organizations on an industry-by-industry and facility-by-facility basis.

On behalf of IRSA, I would like to thank the Committee for the opportunity to testify on this important issue.

APPENDIX A

YMCAs vs. Commercial Multi-recreation Clubs

SELECTED EXPENSE ITEM COMPARISONS

	Commercial Club	YMCA
*Real estate taxes	$ 28,700	$---------
**Sales taxes	10,100	---------
***Income taxes	59,000	---------
+Advertising	66,800	31,900
++Interest Expense	134,700	78,600
	$ 299,300	$ 110,500
TOTAL REVENUES	$1,001,231*	$1,128,595+
Expenses above as percent of total revenue	29.67%	9.87%
+Less % of total revenues received through grants/donations		-12.6%
	29.6%	- 2.8%

TOTAL COST ADVANTAGE ENJOYED BY YMCA: 29.6 - (-2.8) = 32.4%

SIGNIFICANCE OF YMCA'S COST ADVANTAGE: YMCA may charge 32.4% less for similar membership offered by a commercial club.

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*1988 IRSA: State of the Industry Report, compiled for IRSA by the accounting firm Ernst & Whinney, Washington, DC. Figures are for the average multi-recreation club.

**Assumption is that there is an average of 5% sales tax paid and that 50% of the goods in Repair & Maintenance, Housekeeping and General & Administrative are subject to payment of sales tax. Figures derived from Condensed Statement of Operations for Multi-Recreation Clubs in 1988 IRSA: State of the Industry Report.

***Tax calculated by using the corporate tax rate presented in the Federal Tax Guide (p.266, vol. 1; Commerce Clearing House publication).

+Recreation, Sports & Leisure Magazine (July/August 1987)

++Based on average IRSA Multi-Recreation Club interest rate of prime +2%, YMCA interest rate of 70% of prime and prime itself at 10%.

A CASE STUDY IN UNFAIR COMPETITION

Presented By: Alan G. Schwartz, President
Tennis Corporation of America
2020 West Fullerton Avenue
Chicago, Illinois 60647

Subject: The Downtown YMCA of Pittsburgh[1]

Introduction

In 1986, the Y.M.C.A. of Pittsburgh, a non-profit corporation, completed construction of a 12.1 million dollar facility known as the Downtown Y.M.C.A. This facility consists of 8 floors, containing approximately 100,000 square feet, and houses offices, meeting rooms, an olympic swimming pool, indoor running track, plush locker rooms, a massage room, tanning beds, advanced weight training and nautilus equipment, squash and racquetball courts, an indoor gymnasium and basketball court, a pro shop, steam and whirlpool baths, and other state-of-art fitness equipment and facilities.

This new facility replaced what was formerly known as the Golden Triangle Y.M.C.A., a facility located approximately three blocks from the new Downtown Y.M.C.A. The old Golden Triangle Y.M.C.A. was sold to help pay the significant costs of the new Downtown Y.M.C.A., and along with the abandonment of that historical facility, went an abandonment of the charitable purposes previously served by the Y.M.C.A. of Pittsburgh in the downtown area. For, the Golden Triangle Y.M.C.A. had been built primarily to house, and also help, in both a spiritual and physical manner, those transient persons who came to Pittsburgh in search of employment, opportunity and a promising career in industry. The new Downtown Y.M.C.A., however, in this era of an ever-increasing housing shortage for the disadvantaged and escalating homelessness, has none of the Golden Triangle's lodging facilities and has obviously not been conceived, constructed or equipped with even the slightest pretense of being a facility dedicated to those in need of charitable assistance. Rather, it is a commercial facility that seeks to attract the same middle and upper class working persons that are served by private, for-profit health and fitness clubs through offerings of superior facilities and services at a cut-rate price which is subsidized by their tax-favored, charitable classification.

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[1] This Paper has been prepared from evidence, briefs and arguments presented thus far in litigation over the entitlement of this facility to a property tax exemption under Pennsylvania Law. The facility has already been determined to be at least partially taxable and the litigation is presently continuing, primarily because of a dispute as to the proper portion of the total assessed value which should be subject to property taxes. Because of the on-going nature of this litigation, the presenter is somewhat constrained in disclosing certain evidence and testimony which will be presented for the first time at the next level of fact-finding, since such disclosure may impact upon presently-existing litigation strategies and require disclosure of confidential communication.

The local taxing bodies and the for-profit health and fitness clubs have protested and objected to the Y.M.C.A. of Pittsburgh's request for tax-exempt status for this up-scale facility. They content that this new facility is in direct, open and active competition with private for-profit organizations which are required to bear their fair share of the tax burden and that it does not satisfy the basic charitable requirements of actual and regular use of the facility for purposes which benefit legitimate objects of charity. While this issue is, necessarily, one that must be resolved under applicable Pennsylvania law, it is believed that the governing principles and concepts which have shaped that law are analogous to, if not identical to, those which underlie all determinations of charitable exemption. Accordingly, those authorities and considerations presented to the Pennsylvania judicial forums are reiterated here for your review and use in establishing appropriate charitable guidelines.

I. Strict guidelines on statutory exemption from taxation do not reflect a governmental hostility toward charity, but rather, the basic principle that those who benefit from governmental services should, as a general rule, bear their fair share of the costs of those services.

Before beginning to examine the specific case at issue, it is helpful to place in perspective the proper role of tax exemption. A strict legislative or judicial view of entitlement to a tax exemption does not reflect a governmental hostility toward charity or a mere technical application of the rules of law. Rather, it is reflective of the nature and purposes of taxation and the philosophy underlying the grant of an exemption. For, as Mr. Justice Maxey of the Pennsylvania Supreme Court observed in his landmark opinion in Y.M.C.A. of Germantown v. Philadelphia, 323 Pa. 401, 187 A. 204 (1936):

> Taxes are not penalties but are contributions which all inhabitants are expected to make (and may be compelled to make) for the support of the manifold activities of government. Every inhabitant and every parcel of property receives governmental protection. Such protection costs money. When any inhabitant fails to contribute his share of the costs of this protection, some other inhabitant must contribute more than his fair share of that cost. There are substantial reasons why an institution wholly devoted to public charity should be exempt from taxation, since one of the duties of the government is to provide food and shelter for the poor. Any institution which by its charitable activities relieves the government of part of this burden is conferring a pecuniary benefit upon the body politic, and in receiving exemption from taxation it is merely being given a "quid pro quo" for its services in providing something which otherwise the government would have to provide. Just as the exemption of the property of a municipality is founded on the fact that the municipality is a governmental agency of the State, vested by the State with a part of its sovereignty, and employed in aiding the State in matters of government and the execution of its laws, so likewise the exemption from taxation of institutions of public charity is founded on the fact that such a charity is assuming a share of the public burden. The measure of an institution's gratuitous aid to those requiring it is the measure by which the government is relieved of its responsibilities. It

> is therefore just that an institution which assumes pro tanto the taxpayer's burden should be relieved of its own tax burden.

Id. at 413-14, 187 A. at 210[2] (emphasis supplied).

The law, rules and procedures surrounding tax exemption thus focus on the contributions the applicant's facility makes to those poor and unfortunate individuals who would otherwise become more of a burden on government, and whether those contributions are sufficient enough to require the other members of the community to bear the tax burdens which the law would normally place on that facility and its operations. This is a narrow and objective focus which is intended merely to produce an even-handed and fair distribution of the costs of governmental service. It does not by any means depreciate or insult the socially desirable and laudable activities of the many valuable institutions that have been found not to be entitled to exemption and required to pay for their fair share of the governmental services provided to the community. Rather, it merely "restrains our liberality by reminding us that when the tax burden is lifted from the shoulders of one, it must be redistributed among those who remain nonexempt."

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[2] The presenter recognizes that this is not a legal brief and hopes that the readers of this Case Study do not misconstrue these formal citations of authority. They are interposed and interjected merely because the presenter feels that the thoughts contained within these quotations are lucid and noteworthy observations which are worthy of repetition and expressed in clear, understandable language that could not be improved upon by the presenter.

> II. The inquiry in this case, or any other case, does not extend to the laudable or charitable activities carried on by the Y.M.C.A. throughout the City of Pittsburgh or elsewhere. To the contrary, it extends only to the activities, functions and operations actually carried on at the facility which is the subject of the application for exemption. Further, the fact that revenue generated at the subject facility is used to fund or support charitable activities carried on elsewhere does not exempt from taxation those portions of the subject facility and its operations that are used to generate the revenue.

Initially, it should be noted that all are aware of the salutary and charitable activities that have been, and are being, performed by the Y.M.C.A. of Pittsburgh and other Y.M.C.A.s throughout the country. Taxing bodies must surely applaud the selfless efforts that those organizations have made on behalf of the poor and the disadvantaged. Those efforts and activities, as laudable as they may be, are, however, irrelevant to tax exemption to the extent that they are not carried on at the facility in question.

The law should exempt from taxation only that portion of the property or activities of an institution which is actually and regularly used for the charitable purposes of the institution. Moreover, the use of part or all of a facility to generate revenues for the support of the organization's other legitimate charitable activities -- the so-called "Robin Hood" approach to fulfillment of charitable goals -- is not using real property "for the purposes of the institution"; for, as the Supreme Court of Pennsylvania noted over fifty years ago:

> ... The fact that all the net proceeds of a business are used for charitable purposes does not make that business a charitable institution. If any business is manifestly commercial in character, it is not relieved of that classification simply because its earnings are devoted to charity. A tax exemption based on such reasons would be administratively impracticable and lead both to injustice and fiscal confusion.

Y.M.C.A. of Germantown v. Philadelphia, supra. at 412, 187 A. at 209.

In accordance with these basic directives, the courts have consistently and uniformly applied the tests for exemption by looking only to the activities and operations conducted on the specific property, or portion thereof, as to which exemption is at issue. See, e.g. Appeal of Doctor's Hospital, 51 Pa. Cmwlth. 3, 414 A.2d 134 (1980)[3]; Accordingly, the various and sundry activities carried on by the Y.M.C.A. of Pittsburgh at sites or locations other than the Downtown Y.M.C.A. are totally irrelevant to any claim of exemption, as are also any charitable uses to which the Y.M.C.A. of Pittsburgh may put monies or revenues generated at the Downtown Y.M.C.A. from activities that are essentially commercial in character.

III. The Downtown Y.M.C.A. is not entitled to a tax exemption because it is not an institution of purely public charity and is not maintained by an institution of public charity. Rather, it is essentially a commercial facility which is self-supporting, primarily benefits persons who are not legitimate objects of charity, and does not satisfy any of the five criteria identified as indicative of a public charity.

The mere fact the organization is non-profit does not clothe it with an exemption from taxation. Rather, the organization must go farther and affirmatively show that it is an institution of purely public charity and that it is founded and maintained by private or public charity.

The essence of this inquiry is found within the phrase "purely public charity". Chief Justice Nix of the Pennsylvania Supreme Court, in Hospital Utilization Project v. Commonwealth, 501 Pa. 1, 487 A.2d 1306 (1985), performed an exhaustive survey of previous decisions on tax exemption, analyzed their holdings and rationales, and distilled and extracted from those decisions the five principle criteria of a "purely public charity". He found them to be an institution that:

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[3] In Doctor's Hospital, the Court noted at p.9, 414 A.2d at 137, that "... [a]n institution claiming to be charitable must demonstrate that the portion of its property for which exemption is claimed possessed an eleemosynary characteristic ... [and that] the 'actual use and occupation' of the premises is primarily for the designated charitable object...." (emphasis supplied)

a. Advances a charitable purpose;

b. Benefits a substantial and indefinite class of persons who are legitimate objects of charity;

c. Donates or renders gratuitously a substantial portion of its services;

d. Relieves the government of some of its burden; and

e. Operates entirely free from profit motive.

In the case of the Downtown Y.M.C.A., it does not satisfy any of these criteria and, accordingly, that this facility is not an institution of purely public charity or one that should be entitled to any tax exemptions..

A. The Downtown Y.M.C.A. does not advance a charitable purpose.

The Downtown Y.M.C.A. advances a commendable purpose -- improvement of the health, fitness and moral fiber of the population. This, however, is not sufficient to entitle it to a tax exemption. As noted by the Commonwealth Court in Appeal of Doctor's Hospital, supra., at ____, 414 A.2d at 137:

> ... [T]hough an enterprise may be commendable and involve the 'generous contribution of much time and effort on the part of many public spirited people,' it does not therefore automatically possess those eleemosynary characteristics essential to classification as a 'purely public charity.' (citation omitted)

Similarly, in Hospital Utilization Project v. Commonwealth, supra. at ____, 487 A.2d at 1315, Chief Justice Nix observed that:

> ...Although HUP's purpose to improve health care services is commendable, it is not charitable in the legal sense because the direct beneficiaries are its fee-paying clients....

So too, in the case of the Downtown Y.M.C.A., the vast majority of those who benefit from the facility in question are professionals, executives, and other persons in above-average income brackets. Advancing the health and fitness of these individuals, who are quite capable of purchasing the same benefits in the private, for-profit sector, is no more a charitable purpose than is feeding, clothing and housing them. Certainly, no one would suggest that Brooks Brothers, Giant Eagle Markets, and Ryan Homes are pursuing a charitable purpose by providing life's necessities to these very same people. It is submitted, therefore, that providing them with such luxuries as tanning beds, massages, "body sculpting", squash courts, racquetball courts, indoor basketball courts, nautilus equipment, an indoor running track, and steam and whirlpool baths, is not the pursuit of a charitable purpose.

B. The Downtown Y.M.C.A. does not benefit a substantial and indefinite class of persons who are legitimate objects of charity.

Perhaps the most obvious reason why the Downtown Y.M.C.A. is not entitled to tax exempt status is the class of persons to whom the facility has been dedicated. Although it is located in the center of many depressed, low income neighborhoods of the City of Pittsburgh, the Downtown Y.M.C.A. was designed for, and caters to, well-to-do professionals and working persons employed in the downtown business and financial district. In fact, the persons encouraged by the Downtown Y.M.C.A. to use the facilities, through radio advertising and offers of free use for one week, are the executives and employees of:

General Nutrition Corporation
Blue Cross and Blue Shield Insurance
Apple Computer, Inc.
Mellon Bank, N.A.
Union National Bank

Butcher & Singer
Chubb & Sons Insurance Co.
Equibank, N.A.
Rust, Wheelabrator and Swindell Dressler
Pittsburgh National Bank
Johnson & Higgins
Bell of Pennsylvania
Honey Bull, Inc.
Federated Investors
Dravo Corporation
Astorino & Associates
P.P.G. Industries
Duquesne Light Company
Davy McKee, Inc.
I.B.M. Corporation
Carlow College
H.B.M. Creamer
Westinghouse Electric Corporation
JOY Manufacturing
Alcoa
U.S.X.
Equitable Resources
Dravo Consolidated Gas
Arthur Andersen & Co.
Allegheny International
Pittsburgh Press
Penn Group Health Plan
Peoples Natural Gas
Thorp Reed and Armstrong
Touche Ross and Company
Ketchum Communications
Kirkpatrick, Lockhart, Johnson and Hutchinson
Joseph Horne Company
Dollar Savings Bank
Learning International
Harbison Walker Refractories
Paine Webber

There can be no question that these executives and employees are not legitimate objects of charity, but rather, the most well-to-do and fortunate members of society.

These same persons are also, however, the principal beneficiaries of Downtown Y.M.C.A.'s largesse and luxurious new facility. As of November 8, 1987, the Downtown Y.M.C.A. had a total membership of 3,303 persons. Of that number, 2,185 (or 66%) were dues paying "silver" and "gold" memberships; 218 (or 7%) were "complimentary" memberships given to employees of the Y.M.C.A.; 832 (or

25%) were composed of dues-paying youth, student and social members; and the balance of 68 (or 2%) were free or subsidized memberships held by needy persons. The bottom line is, therefore, that 91% of the memberships at the Downtown Y.M.C.A. is composed of persons who can afford to, and do, pay the fees necessary to support the posh, up-scale facility, 7% of that membership is composed of Y.M.C.A. employees who receive their membership as a fringe benefit of employment, and only 2% of that membership is made up of persons who would not otherwise be able to afford the squash courts, tanning beds, massages, whirlpools, plush locker rooms, and other amenities of the facility. This latter class of persons contains the only arguable "legitimate objects of charity", and providing this minuscule portion of the membership with use of the facility does not constitute providing a benefit to a substantial and indefinite class of persons who are legitimate objects of charity.

In fact, the granting of a tax exemption for the Downtown Y.M.C.A. would in effect cause those who are less fortunate to subsidize those persons who are quite able to afford this first-class health club. That is, the property taxes paid by the janitor who cleans the office of an executive who is "working out", getting a massage, having his body "sculpted", or enjoying the tanning beds or whirlpools, are being used to subsidize the reduced dues the executive must pay to use his "tax-free", up-scale facility. That janitor is undoubtedly less fortunate and more needy than is the executive he serves, and there is, therefore, no basis in either logic or the law for exempting from taxation the plush health facility utilized by the executive and imposing upon that janitor and other low or fixed income residents of the area the obligation of bearing the costs of that exemption.

C. The Downtown Y.M.C.A. does not donate or render gratuitously a substantial portion of its services.

The best introduction to this factor is the often-quoted words uttered by the Pennsylvania Supreme Court some thirty years ago:

> ...In all our decisions on this subject there can be discerned as a prerequisite to the taxation exemption of an institution claiming to be benevolent or charitable that it, or the portion of its property in respect to which exemption is claimed, must possess an eleemosynary characteristic not possessed by institutions or property devoted to private gain or profit. What is "given" must be more nearly gratuitous than for a price which impresses one as being proportionate to the services rendered. There must be facts which justify a finding that the "actual use and occupation" of the premises is primarily for the designated charitable object and not largely for commercial purposes.
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> ...A judicial desire to be liberal toward institutions which are doing praiseworthy public work has sometimes led the courts to invest the word "charity," as used in the above excerpt from the Constitution, with a meaning not warranted either lexicologically or by a consideration of the ideology of the constitutional provision invoked. Webster's New International Dictionary, 2d edition, defines a "charity" (in the institutional sense) as "an organization or institution engaged in the free assistance of the poor, incapacitated, distressed, etc." Under this definition the characteristics of an organized charity are: First, whatever it does for others is done free of charge, or at least so nearly free of charge as to make the charges nominal or negligible; second, that those to whom it renders help or services are those who are unable to provide themselves with what the institution provides for them, that is, they are legitimate subjects of charity. For example, if some liberally-disposed person would erect and maintain a dormitory to provide free lodging for well-to-do people, his lodging house could not properly be called a charitable institution. If a person built a lodging house to provide lodging for any personally unobjectionable individuals who might apply, whether they were self-supporting or impoverished, at a cost to those individuals which would yield no profit to the proprietor, such a lodging house would not be a charitable institution.

Y.M.C.A. of Germantown v. Philadelphia, supra., at 409, 411-12, 187 A. at 208-9 (emphasis supplied)

Those statements of the Supreme Court strike right at the heart of the deficiencies in the Downtown Y.M.C.A.'s position. As noted above, 66% of the

Downtown Y.M.C.A.'s members are dues-paying "silver" and "gold" members who pay between $348 and $752 per year for their memberships; 7% of the members are employees who receive their "silver" and "gold" memberships as fringe benefits of employment; and another 7% of the members are students who pay between $174 and $274 per year for their memberships. None of these people, totaling 80% of the membership, are needy and all of them pay (or receive as part of the fringe benefits of their employment) substantial sums for the services provided and the use of the facilities. In fact, representatives of the Downtown Y.M.C.A. have described the prices charged these individuals as "fair compensation" for the services and facilities provided to them.[4]

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[4] The Y.M.C.A. of Pittsburgh has made much to do of its commendable purpose of improving the physical and spiritual health of the community, and the fact that there is nothing wrong with a charity charging for its services. As has already been noted, no issue is taken with the salutary nature of the Y.M.C.A.'s purpose, and there is also no dispute as to the proposition that a charity may accept fees for its services. These two factors do not, however, entitle the Downtown Y.M.C.A. to a tax exemption, for, as Mr. Chief Justice Nix of the Pennsylvania Supreme Court stated recently with respect to the very same argument:

> ...Although HUP's purpose to improve health care services is commendable, it is not charitable in the legal sense because the direct beneficiaries are its fee-paying clients and not the general public.
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> * * *
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> Although a "purely public charity" does not cease to be such where it receives some payment for its services; this reasoning cannot be used to support HUP's argument that an organization which provides no free services qualifies as a "purely public charity" merely because it has good intentions. In the Woods Schools Tax Exemption Case, 406 Pa. 579, 178 A.2d 600 (1962), we stated: "In short, Ogontz emphasized that a school to qualify as a "purely public charity" must donate or render gratuitously a substantial portion of its education services." Id. at 587, 178 A.2d at 604.

Hospital Utilization Project v. Commonwealth, supra., at ____, 487 A.2d at 1315. So too, in the instant case, it is clear that the principal and direct beneficiaries of the Downtown Y.M.C.A.'s plush facility are those dues-paying members whose "fair compensation" in fact supports the facility and its staff. It is, therefore, equally clear that the Downtown Y.M.C.A. is not a "purely public charity", regardless of the fact that it may have commendable purpose and an ability to charge fees.

This leaves a group of 20% that pay less than what the Downtown Y.M.C.A. would describe as "fair compensation". Of that group, 18% are youths who pay $25 per year for their memberships without regard to need, and only 2% are persons who receive free or reduced-rate memberships on account of their inability to pay. The youths are not, however, afforded full use of the facility at all times and are limited to using it during less than one-half of its operating hours throughout most of the year (i.e., for nine months of the year, they are excluded from the facility during its first eight hours of operation). More importantly though, the services provided these youths, even if provided at a bargain rate, do not satisfy the charitable requirement of eleemosynary giving because the alleged nominal charges are as available to the affluent as they are the needy.

As a consequence, the only services rendered "gratuitously" by the Downtown Y.M.C.A. that are relevant to any claimed tax exemption are those rendered to the 2% of its membership that have demonstrated their need for charitable services. The Supreme Court of Pennsylvania has twice held, and often repeated, that even entirely free services to five times this small percentage of needy persons does not satisfy the basic requirement that a substantial portion of the charity's services be rendered gratuitously. Any request of the Downtown Y.M.C.A. for tax exemption should, therefore, surely meet the same fate as did the requests made by the non-profit organizations in the prior cases, since its facility is similarly lacking in the requisite eleemosynary characteristics.

D. The Downtown Y.M.C.A. does not relieve the government of its burdens.

The absence of this factor in the instant situation is almost too plain for argument. The government has never been burdened with providing massages, squash courts, indoor running tracks, tanning beds, computerized aerobic bicycles, computerized rowing machines, nautilus equipment, laundry service, and other fitness luxuries to those who can well afford them. In fact, the government has never considered it necessary to provide those amenities for any members of the populace, either rich or poor. There should, therefore, be no question that the Downtown Y.M.C.A. is not relieving the government of any burdens.

The Y.M.C.A., however, has taken issue with this conclusion on the grounds that it has a youth program previously funded by the Commonwealth of Pennsylvania and other programs that are still funded by governmental bodies or agencies. With respect to the discontinued Pennsylvania youth program, the Y.M.C.A. itself has admitted that it was discontinued by the Thornburg administration because it was a non-essential governmental function. As a consequence, the Y.M.C.A.'s continuation of that program surely could not relieve the government of any burdens, unless one accepts the illogical proposition that the government should be burdened with non-essential government functions. Moreover, with respect to the other programs that are still funded by governmental bodies or agencies, it is difficult to conceive of how the government is relieved of any burdens if it is paying the costs of those programs.

In sum, therefore, the Y.M.C.A.'s assertion that it relieves governmental burdens at its downtown facility is without merit. The Downtown

Y.M.C.A. does not in fact perform any functions that the government would otherwise perform, and there is no reason to exempt it from paying its fair share of the costs of the governmental services it uses.[5]

E. The Downtown Y.M.C.A. does not operate entirely free from profit motives.

The Downtown Y.M.C.A. is a multi-million dollar, first-class health club strategically located in the business district of the City of Pittsburgh. It is not designed for, or marketed to, the many low-income residents of the communities surrounding that business district, but rather, the executives and professionals who commute in and out of that area each working day. Additionally, its facilities and amenities are superior or identical to those offered to the same class of persons by the various for-profit health clubs already established in the downtown business district.

All of this leads to one inescapable conclusion -- the Downtown Y.M.C.A. has entered into a commercial market with products and services that have been proven to yield revenues that will exceed costs and expenses. In fact, the Y.M.C.A. itself freely admits that it expects to realize a surplus of revenues over expenses in the year 1988 in the amount of $8,000, a surplus of revenues over expenses in the year 1989 in the amount of $100,000, and a surplus of revenues over expenses in the year 1990 in the amount of $200,000. The

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[5] To the contrary, exempting the Downtown Y.M.C.A. from taxation would in fact add to governments' burdens. It would remove an enormous asset from the tax rolls, reducing the overall tax base needed to support essential governmental services, and would jeopardize the continuing existence of the several tax-paying, for-profit health clubs whose facilities are virtually identical to, or in some cases inferior to, the Downtown Y.M.C.A. facilities by giving the Downtown Y.M.C.A. an unwarranted competitive edge. Should these competing entities be driven from the market, the governments' tax base will be further reduced, multiplying the strain on governmental resources and further increasing its burdens.

Y.M.C.A., however, contends that this should not be considered to constitute a profit motive because it will use those surpluses to subsidize other facilities and programs. This "Robin Hood" philosophy, as unselfish as it may be, does not entitle the downtown facility to a property tax exemption, for, as the Supreme Court observed in Y.M.C.A. of Germantown v. Philadelphia, supra., at 412, 187 A. at 209:

> ... The fact that all the net proceeds of a business are used for charitable purposes does not make that business a charitable institution. If any business is manifestly commercial in character, it is not relieved of that classification simply because its earnings are devoted to charity. A tax exemption based on such reasons would be administratively impracticable and lead both to injustice and fiscal confusion.

Accordingly, the Downtown Y.M.C.A., by its own admission, must be found to have a profit motive that is inconsistent with its asserted right to a property tax exemption.

IV. THE DOWNTOWN Y.M.C.A. IS READILY DISTINGUISHABLE FROM ITS TAX-EXEMPT PREDECESSOR, THE GOLDEN TRIANGLE Y.M.C.A., AND NONE OF THE FACTORS WHICH RESULTED IN THE GRANTING OF EXEMPT STATUS TO THAT PREDECESSOR FACILITY ARE PRESENT IN THE Y.M.C.A.'S NEW DOWNTOWN FACILITY.

In 1954, the Golden Triangle Y.M.C.A., predecessor to the present facility, was determined by Judge Montgomery of the Court of Common Pleas of Allegheny County, Pennsylvania to be a purely public charity entitled to tax exemption. See, Y.M.C.A. of Pittsburgh Appeal, 4 D. & C. 2d. 186 (1954). That decision was affirmed by the Pennsylvania Supreme Court, which adopted Judge Montgomery's learned Opinion. In granting that exemption, the contrary determination reached in Y.M.C.A. of Germantown v. Philadelphia, supra., was distinguished on the basis of the following "salient factors:"

1. The Golden Triangle Y.M.C.A. was not commercial in character.

2. The Golden Triangle Y.M.C.A. did not compete with commercial facilities.

3. The Golden Triangle Y.M.C.A. did not advertise its facilities.

4. The Golden Triangle Y.M.C.A. accepted a class of society that could not afford other accommodations.

5. The Golden Triangle Y.M.C.A. was "open only to a special class of society which was in need of charitable assistance".

6. The rates charged by the Golden Triangle Y.M.C.A. were much lower than those charged by commercial establishments.

7. The accommodations furnished by the Golden Triangle Y.M.C.A. were not at all comparable to the accommodations furnished by available commercial establishments.

The new Downtown Y.M.C.A. is a far cry from that predecessor, and not only because of the absence of the lodging facilities at issue when the tax-exempt status of the Golden Triangle Y.M.C.A. was examined. To the contrary, the new Downtown Y.M.C.A. has set itself apart from its forerunner by failing to possess a single one of the "salient factors" that were found by the Pennsylvania Courts to warrant property tax exemption for the Golden Triangle Y.M.C.A.:

1. The new Downtown Y.M.C.A. is entirely commercial in character. It has been developed for the admitted purpose of generating hundreds of thousands of dollars in surplus revenues, and it collects those revenues in the most commercially efficient manner possible -- Visa, Mastercharge, and automatic electronic fund transfers.

2. The new Downtown Y.M.C.A. is in direct and active competition with commercial facilities. The prices charged its members are comparable to those charged by commercial establishments which offer the same (or in most cases, inferior) facilities and services. Further, the new Downtown Y.M.C.A. also has a retail "pro shop" or store that sells sporting goods for retail prices.

3. The new Downtown Y.M.C.A. has aggressively and actively advertised and marketed its facility on the radio, in the newspaper, and through promotional offers of free use to corporate executives and employees. In fact, the new Downtown Y.M.C.A. has a multitude of "corporate" members who receive a 25% discount on dues which, in the aggregate, exceeds by many times the discounts or subsidies given to the few needy persons to whom the Downtown Y.M.C.A. has granted memberships.

4. As noted previously in this Memorandum, the new Downtown Y.M.C.A.'s membership is composed almost exclusively of those who can well afford the type of facilities and services it provides.

5. The new Downtown Y.M.C.A. is not "open only to a special class of society which is in need of charitable assistance", but rather, it is open primarily to, and used primarily by, those classes of society that are not in need of any assistance whatsoever.

6. The rates charged by the new Downtown Y.M.C.A. are not much lower than those charged by commercial establishments and, as its own internal memorandum shows, are in many cases higher than the nearby commercial establishments.

7. The facilities and services furnished by the new Downtown Y.M.C.A. are more than comparable to those furnished by available commercial establishments. The new Downtown Y.M.C.A. is, by its own description, the most modern fitness facility in the area, possessing the largest physical size, the largest variety of fitness activities, and the most comprehensive array of state-of-the-art fitness equipment.

The new Downtown Y.M.C.A. is not, therefore, the same facility that presented itself to the taxing bodies in 1954. Instead, it is a completely transformed operation that has taken on all of the characteristics of for-profit, commercial facilities and cast aside the various characteristics that once entitled it to a property tax exemption. Certainly that same major transformation of functions, attitude and service must also work a transformation of tax status.

CONCLUSION

The fundamental question underlying the Y.M.C.A.'s request for tax exemption is simply whether the Downtown Y.M.C.A. should bear its fair share of the costs of the governmental services provided to the community. The resistance to the Y.M.C.A.'s request by the governmental bodies that provide those services is not based upon any lack of appreciation for the Y.M.C.A.'s laudable contributions, but upon the equitable notion that any facility which is essentially commercial in character should be treated the same as all other such facilities.

The Downtown Y.M.C.A. falls squarely into this category. It is a state-of-the-art facility to which the Y.M.C.A. of Pittsburgh has devoted 43% of its twenty-five to thirty million dollars in available assets. The product of this investment, the Downtown Y.M.C.A., is absolutely indistinguishable from the commercial health clubs operating in downtown Pittsburgh, and it derives its support from the same dues and class of persons that are relied upon by those commercial clubs to support their operations. It is unquestionably a substitute for those commercial facilities, and it is in obvious and direct competition with them. The Downtown Y.M.C.A. must, therefore, be treated in the same manner as those similarly situated enterprises with respect to the tax burdens imposed to pay the costs of essential governmental services provided without discrimination to the Downtown Y.M.C.A., other health clubs, and all other businesses and citizens.

STATEMENT OF
CHARLES E. NELSON
PRESIDENT, MICHIGAN MEDICAL SUPPLY, INC.
ON BEHALF OF
MICHIGAN DURABLE MEDICAL EQUIPMENT CRISIS COMMITTEE
BEFORE THE COMMITTEE ON SMALL BUSINESS
REPRESENTATIVE JOHN J. LAFALCE, CHAIRMAN
UNITED STATES HOUSE OF REPRESENTATIVES
ON
NON-PROFIT COMPETITION
PRESENTED ON OCTOBER 1, 1988
CHICAGO, ILLINOIS

MR. CHAIRMAN, ON BEHALF OF THE MANY SMALL BUSINESS OWNERS, PARTICULARLY THE HOME MEDICAL EQUIPMENT INDUSTRY, I THANK YOU FOR THE OPPORTUNITY TO APPEAR BEFORE YOU AT TODAY'S HEARING. I AM HERE TODAY REPRESENTING MICHIGAN MEDICAL SUPPLY, INC. AND AS PRESIDENT OF THE MICHIGAN DURABLE MEDICAL EQUIPMENT CRISIS COMMITTEE, WHICH REPRESENTS SEVENTEEN MEDICAL EQUIPMENT SUPPLIERS IN MICHIGAN.

MR. CHAIRMAN, I CONGRATULATE YOU AND THE COMMITTEE MEMBERS FOR HOLDING THESE HEARINGS. THE REVOLUTION IN HEALTH CARE HAS BROUGHT ABOUT PROBLEMS WHICH ARE AFFECTING US ALL; PROBLEMS FOR WHICH THERE ARE NO QUICK ANSWERS, BUT WHICH DEMAND ATTENTION AND THOUGHTFUL SOLUTIONS.

BACKGROUND

DURING THE LATE-NINETEEN SIXTIES AND EARLY SEVENTIES, THE NATIONAL COST FOR HEALTH CARE WAS SKYROCKETING. BECAUSE HOSPITALS WERE BEING REIMBURSED ON A "COST-BASED REIMBURSEMENT" SYSTEM, THERE WAS LITTLE INCENTIVE FOR PATIENTS TO BE DISCHARGED IN A TIMELY FASHION. THUS, HEALTH CARE COSTS WERE RISING FASTER THAN THE GNP. HEALTH CARE COSTS WERE ALSO ADVERSELY AFFECTED BY INCREASING TECHNOLOGICAL ADVANCES IN MEDICINE, INCREASING LABOR COSTS, DUPLICATION OF SERVICES, AND INCREASING COMPETITION BETWEEN HOSPITALS.

BY THE LATE-NINETEEN SEVENTIES AND EARLY EIGHTIES, THE FEDERAL GOVERNMENT FINALLY REALIZED THAT THE "COST-BASED REIMBURSEMENT" FORM OF REIMBURSEMENT WASN'T WORKING AND INSTITUTED CHANGES WHICH HAVE PRECIPITATED THE "REVOLUTION IN HEALTH CARE." A PROSPECTIVE PAYMENT SYSTEM WAS DEVELOPED AFTER EXTENSIVE RESEARCH AT HARVARD UNIVERSITY CALLED DIAGNOSTIC RELATED GROUPS, BETTER KNOW AS DRG'S. THIS NEW FORM OF REIMBURSEMENT PLACES THE INCENTIVE ON EARLY DISCHARGE. THUS, PATIENTS ARE BEING DISCHARGED FROM HOSPITALS AT A FASTER RATE THAN EVER BEFORE.

MANY LARGE REGIONAL REFERRAL CENTERS, BECAUSE OF THEIR SHEER VOLUME OF ADMISSIONS AND DISCHARGES, DISCOVERED THAT THE "PPS" FORM OF REIMBURSEMENT WAS ACTUALLY GENERATING MORE REVENUE THAN THE OLD "COST-BASED" FORM OF REIMBURSEMENT. THIS SYSTEM HAS

ENCOURAGED NON-PROFIT HOSPITALS TO ENTER THE FOR-PROFIT POST-DISCHARGE HEALTH CARE MARKET IN EVER-INCREASING NUMBERS. THESE ORGANIZATIONS USE THEIR TAX-EXEMPT ECONOMIC POWER, THEIR STANDING IN THE COMMUNITY, AND THEIR EXCLUSIVE ACCESS TO PATIENTS IN THEIR HOSPITALS TO INCREASE REVENUES AT THE EXPENSE OF PATIENTS AND TO THE DETRIMENT OF COMPETITION. PATIENTS ARE BEING "STEERED" BY HOSPITAL EMPLOYEES TO COMPANIES IN WHICH THE HOSPITAL HAS A FINANCIAL INTEREST. REFERRALS ARE BEING MADE ON THE BASIS OF PROFIT MOTIVE AND NOT IN THE INTEREST OF QUALITY HEALTH CARE.

OF COURSE, COMPANIES SUCH AS OURS FEEL THE FINANCIAL PINCH OF BUSINESS. HOWEVER, THE REAL LOSERS ARE PATIENTS AND THE GENERAL PUBLIC WHO ARE DEPRIVED OF THE BENEFITS OF FREE COMPETITION. WHERE REAL COMPETITION EXISTS, THE PEOPLE BENEFIT THROUGH BETTER SERVICE AND LOWER PRICES. THAT KIND OF HEALTHY COMPETITION IS RAPIDLY BEING ELIMINATED BECAUSE OF THE ENCROACHMENT OF NON-PROFIT HOSPITALS IN THE TRADITIONALLY FOR-PROFIT AREAS OF HEALTH CARE.

NON-PROFIT CHARITABLE HOSPITALS

TODAY'S REGIONAL REFERRAL HOSPITAL IS OFTEN A LARGE, NON-PROFIT, MULTI-MILLION DOLLAR ORGANIZATION WHICH IS RUN AS A BUSINESS, USING MANAGEMENT TECHNIQUES DEVELOPED FOR LARGE CORPORATE ORGANIZATIONS. OFTEN THESE HOSPITALS CONSIST OF MULTI-TIERED ORGANIZATIONS WITH A NON-PROFIT PARENT AND SEVERAL, SOMETIMES DOZENS, OF FOR-PROFIT SUBSIDIARIES. TRAVEL AGENCIES, PHARMACIES, REAL ESTATE HOLDINGS, HEALTH CLUBS AND MEDICAL EQUIPMENT COMPANIES ARE ONLY A FEW EXAMPLES OF WHERE THE "NON-PROFIT" DOLLARS ARE BEING SHIFTED.

MR. CHAIRMAN, WE ALL SHARE IN THE WELL-BEING OF OUR HOSPITALS, BECAUSE THEY ARE ESSENTIAL TO A CIVILIZED SOCIETY. HOWEVER, MOST HOSPITALS, BECAUSE OF THEIR NON-PROFIT STATUS, HAVE AN UNFAIR COMPETITIVE ADVANTAGE OVER THE INDEPENDENT FOR-PROFIT BUSINESS PERSON. MANY OF THE UNFAIR COMPETITIVE ADVANTAGES INCLUDE POSTAL RATE SUBSIDIES, STATE AND LOCAL PROPERTY TAX EXEMPTIONS, AND STATE SALES TAX EXEMPTIONS. POSSIBLY THE LEAST TANGIBLE BENEFIT THAT A NON-PROFIT HOSPITAL CAN POINT TO, BUT A BENEFIT THAT MAY BE ITS MOST IMPORTANT STOCK IN TRADE, IS WHAT CAN BE CALLED THE "HALO EFFECT;" i.e., THE BELIEF OF THE PUBLIC THAT A NON-PROFIT CHARITABLE HOSPITAL IS OPERATING ON BEHALF OF THE PUBLIC WELFARE AND THAT ITS EFFORTS ARE NOT TAINTED BY THE NEED TO MAKE A PROFIT. THE HALO EFFECT MEANS THAT THESE NON-PROFIT CHARITABLE HOSPITALS HAVE, EITHER BY THEIR DEEDS OR BY PEOPLE'S PERCEPTIONS, INCURRED A SUBSTANTIAL AMOUNT OF GOODWILL WITHIN THE GENERAL PUBLIC.

CURRENT PROBLEMS

BECAUSE OF THE "PPS" FORM OF REIMBURSEMENT, EARLY DISCHARGES HAVE BECOME THE HOSPITALS' GOAL. ANOTHER WAY IN WHICH COSTS CAN BE CONTROLLED IS TO ALLOW PATIENTS TO RECUPERATE AT HOME. DURABLE MEDICAL EQUIPMENT COMPANIES FURNISH MEDICAL EQUIPMENT AND

SUPPLIES FOR USE BY PATIENTS UPON DISCHARGE FROM THE HOSPITAL. HOWEVER, ENTRY OF HOSPITALS INTO THIS MARKET HAS AFFECTED MANY SMALL BUSINESSES, INCLUDING MY OWN. A GROUP OF SEVENTEEN COMPANIES IN MICHIGAN HAVE FORMED THE MICHIGAN DURABLE MEDICAL EQUIPMENT CRISIS COMMITTEE TO ADDRESS COMMON ISSUES SUCH AS THESE FACING OUR INDUSTRY.

ONE EXAMPLE OF UNFAIR COMPETITION FROM NON-PROFIT HOSPITALS IS OCCURRING IN MY AREA OF OPERATION. A LARGE REGIONAL HOSPITAL OWNS A FOR-PROFIT DME COMPANY WHICH SIGNED A JOINT VENTURE CONTRACT WITH A RURAL COMMUNITY HOSPITAL IN 1986. MY COMPANY HAD BEEN SERVICING THIS RURAL HOSPITAL SINCE 1980, AND FELT THE IMMEDIATE EFFECT OF THIS JOINT VENTURE CONTRACT AS REVENUES AND REFERRALS BEGAN TO FALL OFF. REVENUES GENERATED FROM THIS HOSPITAL FELL MORE THAN 90% AFTER THE JOINT VENTURE CONTRACT WAS SIGNED. THE HOSPITAL DME COMPANY CURRENTLY PAYS THE HOSPITAL $75.00 FOR EACH OXYGEN AND APNEA MONITOR PATIENT SET UP IN THE HOME, IN ADDITION TO A $55.00 MONTHLY FEE PER PATIENT "VISIT." IN RETURN, THE HOSPITAL AGREES TO REFER ALL PATIENTS IT CAN TO THE COMPANY. THIS ARRANGEMENT PROVIDES FINANCIAL INCENTIVE TO THE HOSPITAL TO DIRECT ALL REFERRALS FOR DME TO THE "CONTRACTED" HOSPITAL-OWNED DME COMPANY. THE FEES PAID TO THE RURAL HOSPITAL FOR THE PATIENT SET UPS AND FOLLOW-UPS ARE MORE THAN DOUBLE THOSE PAID BY AREA DME COMPANIES TO THEIR EMPLOYEES. THIS SITUATION DESTROYS COMPETITION BECAUSE THE HOSPITAL LINES ITS OWN POCKETS AT THE EXPENSE OF COMPETITION. THE SEVERE DECREASE IN REFERRALS

FROM THIS TYPE OF ARRANGEMENT HAS BEEN DEVASTATING TO MY COMPANY AS WELL AS OTHER INDEPENDENTLY OWNED COMPANIES.

WITHOUT MEANINGFUL COMPETITION, THIS TYPE OF ARRANGEMENT CAN LEAD TO CONSUMERS PAYING HIGHER PRICES. AN EXAMPLE OF THIS HAPPENED IN FEBRUARY OF 1981. AN ELDERLY PATIENT WHO WAS IN NEED OF A HOME AEROSOL GENERATOR FOR CHRONIC ASTHMA WAS DISCHARGED FROM ANOTHER HOSPITAL IN MICHIGAN. BECAUSE THE HOSPITAL HAD A JOINT VENTURE CONTRACT WITH A DME COMPANY OWNED BY A LARGE HOSPITAL COMPANY, THE PATIENT WAS SEEN BY A THERAPIST FROM THE CONTRACTED DME COMPANY AND PAID $250.00 FOR THIS UNIT. WHEN HE SAW THE SAME UNIT AT A RETAIL LOCATION SELLING FOR A "SUGGESTED LIST" PRICE OF $160.00, HE BECAME FURIOUS AND WENT TO THE LOCAL NEWSPAPER.

AS I HAVE NOTED, CONSUMERS SUFFER AS A RESULT OF THIS TYPE OF ARRANGEMENT BECAUSE THEY ARE DEPRIVED OF A FREE CHOICE. A HOSPITAL IN NORTHERN MICHIGAN OPENED THEIR OWN DME COMPANY AND LOCAL INDEPENDENT DME COMPANIES FELT THE IMMEDIATE EFFECT. ONE COMPANY HAS OVER TWO DOZEN SIGNED DOCUMENTS FROM PATIENTS STATING THEY WERE NEVER GIVEN A CHOICE OF WHO WAS TO PROVIDE THEIR HOME MEDICAL EQUIPMENT.

OTHER HOSPITALS USE SOPHISTICATED COMPUTER SYSTEMS TO DIRECT ALL OF THESE "CAPTIVE" REFERRALS TO THEIR OWN COMPANY. AT THE SAME TIME, THEY DENY COMPETING COMPANIES ACCESS TO THE PATIENTS

AND DISCHARGE PLANNER, WHICH ARE THE VERY LIFE LINE OF THEIR EXISTENCE.

SUMMARY

MR. CHAIRMAN, THE INCURSION OF NON-PROFIT, NON-TAXABLE HOSPITALS INTO THE DME INDUSTRY HAS CREATED SIGNIFICANT PROBLEMS FOR NOT ONLY THE INDEPENDENT MEDICAL SUPPLIER BUT, MORE IMPORTANTLY, FOR THE CONSUMER OF HEALTH CARE PRODUCTS IN THIS COUNTRY. AS STATED BY AARP AT THE MAY 12, 1986 HEARING BEFORE THE SELECT COMMITTEE ON AGING: "WE START FROM THE PREMISE THAT THE NEEDS OF CONSUMERS ARE MORE IMPORTANT THAN THE NEEDS OF HOSPITAL ADMINISTRATORS."

THE ELIMINATION OF FREEDOM OF CHOICE AND THE "CORNER THE MARKET" POLICY THAT HOSPITALS ARE CURRENTLY EXHIBITING ARE DESIGNED TO DESTROY THE BENEFITS OF FREE COMPETITION - LOWER PRICES AND BETTER SERVICE. ALTHOUGH IT IS DIFFICULT TO GET SERIOUSLY ILL PERSONS TO COME BEFORE YOU AND TESTIFY, YOU SHOULD BE AWARE THAT THIS IS A GROWING "CONSUMER CONCERN." AARP IS CONCERNED AND THE MEDICAL SYSTEM IN MICHIGAN IS CONCERNED. THESE HEARINGS ARE EVIDENCE OF A GROWING FEDERAL CONCERN.

RISING HEALTH CARE COSTS IS A PROBLEM THAT WON'T GO AWAY AND IT MUST BE DEALT WITH. ULTIMATELY, THE ONLY VIABLE ANSWER TO THIS PROBLEM IS ENSURING THAT FREE COMPETITION IS PROTECTED.

NAMES

STATEMENT OF
THOMAS E. INMAN, II
PRESIDENT

BEFORE THE

COMMITTEE ON SMALL BUSINESS
U.S. HOUSE OF REPRESENTATIVES

HEARING ON

NON-PROFIT COMPETITION

JUNE 29,1988

NAMES

Statement of Thomas E. Inman II

Mr. Chairman, and Memebers of the committee

My name is Thomas E. Inman, II and I am President of Virginia Home Medical. My company is a 10-year old small business in Newport News, Virginia, with branches in Norfolk and Chesapeake. Our mission is that of supplying medical equipment and supplies to individuals suffering from either chronic or terminal illnesses. The majority of our activity takes place in a person's home after we are contacted by a referral source. Some examples of our product line include home oxygen therapy, enteral feeding therapy, hospital beds, wheelchairs, and other special or customized rehabilitation products.

The purpose of my submitting testimony before this committee is to help the members of the committee better understand two specific types of unrelated business income which are being generated by non-profit health organizations. Both of these types of activities are inherently unfair to the tax paying small business community, and beyond that they may well evolve into a broader strategy, which when expanded, will cause serious casualties to small business and, thus, a negative impact on the 37% of GNP, which small business represents to this nation.

As and example of the first type of tax-exempt unrelated business income generated by non-profit organizations, may I describe an experience our company had in the early 80's. We had invested approximately $500,000 in home infant monitors as a result of new product technology and community need. Our home monitoring program had become accepted by local phsicians and parents alike, for those newborns who were identified as being at risk to sudden infant death syndrome (SIDS). One of our local non-profit hospitals conducted an annual fund raising event which was sponsored by a local service sorority. For this particular year, the one-day event raised over $29,000. Included in the next issue of the hospital's newsletter was a feature story with a picture of the sorority officers presenting the donation check to hospital officials. Within the body of the article, the statement was made which indicated that approximately $15,000, of the donated funds were going to be used to purchase home infant monitors for the hospital's patients. As a direct result of the diversion of the donated non-taxed funds into a "non-related" business activity, my tax-paying company suffered severe business consequences. Additionally, once a non-profit entity becomes aware of this method of "free venture capital", they can duplicate it over again specific to their areas of interest.

National Association of Medical Equipment Suppliers, 625 Slaters Lane, Suite 200, Alexandria, Virginia 22314, (703) 836-6263

The second type of non-taxed income I would like to describe for the committee is that which is occurring in the health care industry on a daily basis. In recent years non-profit hospitals across the country initiated complex structural reorganizations in an attempt to remove certain types of activities and incomes from direct scrutiny. These structural changes characteristically have a non-profit holding company or foundation owning a multi-layered group of entities; some of which are for-profit and other are not-for-profit. The point to be made here is that the Internal Revenue Code allows for the intergration under common ownership of both for-profit and not-for-profit entities. With this type of legal structure, defining non-related business income or activities for the whole organization becomes a very difficult task for the IRS.

Given the above referenced state of affairs a closer look into the possible flow of non-taxed income and donations, (as mentioned in the first example) is warranted. Appendix A outlines two for-profit companies with the only difference in them being that one is owned by a non-profit entity. It becomes apparent that one entire layer of taxation is being avoided by non-profit ownership at the point when dividends are distributed to stockholders. However, there is a far more omnious transaction which has the small businessman concerned. That transaction is the specific incentive to take full advantage of the federally allowed 10% tax deductable contribution to a 501 corporation. The facts slap small businessmen in the face when they come to realize that a tax-deductible contribution not only reduces the taxes to be paid, but also acts as a tax free, dividend distribution when it is made to the parent 501 holding company or another member of the family of 501 corporations under the parent-holding company.

Gentlemen, I submit to you that when this type of government sanctioned economic control and power is allowed to continue over the next decade, there will be a redistribution of taxes off of the small business community, due to their decreasing numbers, and onto the individual taxpayer. The reason I make such a strong statement is that when the total of the transactions is evaluated for the economic impact on both small business and the tax base, one fact becomes clear: fair competition is impossible. The bottom line for a 501 owned for-profit corporation after dividend distribution, and the receipt of the up-front 10% donation is that the holding company strategy equates to a 76% tax advantaged economic position over an individually owned corporation. Additionally, with these advantaged dollars the holding company is now free to use them as "venture capital" to expand its economic base.

The point to be made here is that we find ourselves in the dilemma of not only asking questions relevant to defining unrelated business income, but more importantly how the laws effecting the structure of multi-layered hybrid organizations allow them to legally excape scrutiny relative to non-related business income due to extremely broad mission statements, common boards of directors and continued use of "tax-free" dividends as venture capital to expand their organizations.

In closing, I would like to say that I share this committee's concerns in taking a fair and objective look at the facts surrounding this issue. Currently I am serving as a citizen member to a Joint Subcommittee of the Virginia General Assembly. We, too, are addressing the issue of non-related business income as one aspect of our study of unfair competition between non-profit organizations and the small business community in the Commonwealth. This issue is vital to the future economy of our nation and to the continued contributions the small businessman will be allowed to make to this nation in the decades to come.

APPENDIX A

Net Equity Analysis For Two For Profit Corporations

	Non-profit Ownership		Taxable Ownership
Taxable Income	1,000,000		1,000,000
10% Tax Deductible Contribution	100,000		100,000
Net Taxable Income	900,000		900,000
Est. Corp. Taxes	300,000		300,000
Net Income Available For Distribution	600,000		600,000
Taxes On Total Distribution			
Individual Rate at 28% Federal	-0-		168,000
Individual Rate at 5.75% State			34,500
Total Taxes On Divident Distribution	-0-		202,500
Net Effect To Stockholders	600,000 +100,000	 (Donation)	600,000 -202,500
	700,000		397,500

NCCA
Networking The Nation's Professionals For Quality Child Care
National Child Care Association

July 18, 1988

The Honorable John LaFalce
Chairman, Committee on Small Business
2361 Rayburn House Office Building
Washington, D.C. 20515-6315

Dear Chairman LaFalce:

I am writing on behalf of the National Child Care Association (NCCA), a federation currently comprising 22 State Associations of for-profit, small business, child care providers. The for-profit or proprietary, child care industry is estimated to represent 55-60 percent of center-based, child care in the nation, with almost 35,000 centers.

We commend you and your Committee on Small Business for initiating hearings into the ongoing and growing problem of unfair competition between tax-exempt organizations and tax-paying small businesses.

Not only does exemption from Federal taxation provide tax-exempts and related entities with substantial tax-payer subsidized, competitive advantages, but such an exemption triggers a wide variety of other benefits - exemptions from State and local taxes, from property taxes, favorable postal rates, access to public service advertising, lower liability insurance rates the ability to receive United Way and other tax-deductible contributions, etc.

The proprietary child care industry continues to face unfair (tax-payer subsidized) competition from three major sectors:

DIRECTOR
OF GOVERNMENT AFFAIRS
William J. Tobin
William J. Tobin & Assoc.
1050 K Street, Suite 500
Washington, DC 20006
T (202) 776-8118

(1) Governmental entities at all levels - e.g. park and recreation authorities, public school systems, etc. where frequently stringent requirements are established by legislative bodies and these entities are explicitly exempted;

(2) Church-related, tax-exempt entities - where oftentimes, volunteer help, the "halo-effect" and "captive referrals" take place; and

(3) Tax-exempt organizations - such as United Way funded YMCAs and tax-exempt hospitals and clinics which have been able to expand their lucrative endeavors, especially in the more affluent suburbs and in the executive confines of downtown business areas. The net-revenues (or "profits") are used for increased salaries and staff benefits, or subsidized center and program expansion.

We look forward to working with you to establish a more level playing field in the area of child care. It oftentimes is difficult to compete against tax-payer subsidized organizations. But with your help, and hopefully your planned field-hearings, equitable resolutions can be found.

Cordially,

William J Tobin

William J. Tobin
Director of Government Affairs

P.S. Even the currently proposed Act for Better Child Care, "the ABC Bill" (H.R. 3660/S. 1985), in most areas excludes the proprietary child care sector from participating in this massive expansion of child care services.

NATIONAL HEARING AID SOCIETY

20361 MIDDLEBELT • LIVONIA, MICHIGAN 48152 • TELEPHONE: (313) 478-2610

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Seattle, Washington
Governor-at-Large:
WILLIAM L. SYERS
Davenport, Iowa

July 18, 1988

The Honorable John J. LaFalce
Chairman, Committee on Small Business
2361 Rayburn House Building
Washington, D.C. 20515-6315

Dear Chairman LaFalce:

On behalf of the National Hearing Aid Society (NHAS), I am writing to you regarding the hearings your Committee on Small Business are conducting concerning the vexing and pervasive problem of competition between tax-exempt organizations and tax-paying, small businesses.

NHAS is the international professional association of hearing aid specialists. The approximately 4,000 NHAS members in the United States and abroad are trained and licensed to test human hearing, and select, fit and service hearing instruments. NHAS was founded thirty-seven years ago to ensure the provision of competent professional assistance to the millions afflicted by hearing impairments. As the principal accrediting body for professionals engaged in the testing of hearing, selection, fitting, sale and servicing of hearing instruments, NHAS administers a demanding certification program and conducts study courses and seminars. Historically it has been said that NHAS represents the vast majority of sales of hearing aids in the U.S.

The hearing aid dispensing field is truly a small business industry employing approximately 8,000 individuals. (Yet, during the 1986 White House Conference on Small Business, our industry was represented by 18 out of the 1,800 delegates because of their strong concerns over the unfair competition issue).

Our small but important industry to millions of hearing impaired Americans, has been severely impacted by unfair, tax-exempt competition for at least 11 years. This has been marked by highly localized lost-selling opportunities.

However, a recent development is causing us particular concern. During 1988, the Pharmacy Service subsidiary of the tax-exempt American Association of Retired Persons has begun to test market the sale of hearing aids in two areas - Richmond, Virginia and suburban Portland, Oregon. This subsidiary alone of this nationwide membership giant already provides the AARP with $1.5 million in annual royalty revenues. One would shudder to think what an all out, nationwide hearing aid sales program would do to our small business members.

Despite the fact that there were ethical constraints on hearing aid sales, during the past decade we have experienced unfair competition from all levels of the tax-exempt world:

1) Quasi-Governmental entities - State universities, as part of an audiology curriculum program, have instituted programs dispensing hearing aids, under the guise of "training" audiology students in fitting and selling hearing aids. (One wonders what the purpose of a master's level program in audiology is -- a university, academic program, or a vocational, technical school?) Moreover, Eastern Michigan University in Ypsilanti has been dispensing hearing aids, but has no degreed program in audiology, but only in speech pathology;

2) Religiously Affiliated Organizations - Some components of the Alexian Brothers hospital system, for example, have been regularly dispensing hearing aids to the non-patient, public for several years; and

3) Other Tax-Exempt Organizations - United Way funded entities across the country, such as Easter Seal Society affiliates in Austin, Texas and Sioux City, Iowa, as well as the Eastern Maine Medical Center in Bangor, Maine, the Central Florida Speech and Hearing Center in Lakeland, Florida and the Northwest Speech and Hearing Clinic in Seattle, Washington have been selling hearing aids.

Because the Federal tax-exemption declaration triggers so many other advantages -- State and local property tax-exemption, advantageous postal rates and the combined effect of the "halo-effect" and "captive referrals", our hearing aid dispensers need the help of the Committee on Small Business, if we are to survive as an industry. We enthusiastically endorse your announced intention to conduct a series of field hearings whereby you can view the severity of the problems firsthand.

We have urged the use of a very restricted use of the term "patient" to the Subcommittee on Oversight of the Ways and Means Committee -- one that involves a formal relationship to a hospital, such as "one who has been admitted to a hospital," as part of a solution.

Another would be the adoption of the recommendation of the Small Business Administration (SBA) that the IRS institute an expedited, administrative channel for the filing and review of complaints relating to the commercial activities of tax-exempt organizations. The protective spirit of UBIT and administrative efficiency of the IRS can be better served if the IRS has access to information targeting potential noncompliance with the law. Tax-paying small businesses are in the best position to identify potential violations of the law, but currently have no formal mechanism to do so.

Mr. Chairman, we look forward to your leadership in developing a series of proposals to restrict or eliminate the unfair, commercial competition we are experiencing more and more from the tax-exempt world. We pledge to work with you in developing these proposals.

Cordially,

James P. Lovell

James P. Lovell
Government Relations Director
National Hearing Aid Society

P.S. One final thought. Currently, hearing aids are not reimbursable under the Medicare program. It has been suggested that Federal coverage be included, as recently as a month ago by Congressman Pepper. Should this ever occur, the rush to get involved, tax-free, in reimbursable hearing aid sales by tax-exempts, would be astonishing and to the existing hearing aid small businesses fatal.

NATIONAL INDUSTRIES FOR THE BLIND
524 Hamburg Turnpike, CN969, Wayne, New Jersey 07474-0969 • 201-595-9200

GEORGE J. MERTZ
President

July 28, 1988

The Honorable John J. LaFalce
Chairman
House Small Business Committee
2361 Rayburn House Office Building
Washington, DC 20515-6315

Dear Congressman LaFalce:

On June 28 and 29, 1988, the House Small Business Committee held hearings to explore the issue of competition by nonprofit organizations with small business. We applaud your efforts to address an issue which is quite complex and controversial, and to approach it in an objective manner.

National Industries for the Blind would like to submit a written statement for the hearing record. As the Central Nonprofit Agency for workshops for the blind participating in the Javits-Wagner-O'Day program, we are interested in concerns which have been raised about unfair competition and unrelated business income tax (UBIT). It is important that any legislative or regulatory changes in UBIT or any recommendations generated by your Committee not affect the availability of employment opportunities for blind Americans which is the primary goal of nonprofit sheltered workshops for the blind.

Sincerely,

George J. Mertz
George J. Mertz

GJM:ymn

STATEMENT OF

GEORGE J. MERTZ, PRESIDENT

NATIONAL INDUSTRIES FOR THE BLIND

FOR

HOUSE SMALL BUSINESS COMMITTEE

JULY 25, 1988

A. INTRODUCTION:

National Industries for the Blind (NIB) is a private, section 501 (c)(3) nonprofit agency incorporated in the state of New York on August 10, 1938. Its purpose, as stated in its Certificate of Incorporation, is to promote the welfare of blind persons in general and blind workers in particular. Shortly after the passage of the original Wagner-O'Day (WOD) Act in 1938, NIB was designated by the Presidentially appointed Committee on Purchases of Blind-Made Products as the Central Nonprofit Agency (CNA) to represent workshops for the blind participating in the WOD employment program. As the designated CNA, NIB works closely with the successor Committee for Purchase from the Blind and Other Severely Handicapped and federal procurement agencies in assisting agencies for the blind to provide increased employment opportunities for blind people.

We applaud the Small Business Committee efforts to examine whether or not nonprofits enjoy a competitive advantage in the marketplace and the reasons for the growth in income producing activities of nonprofits; to identify those nonprofit organizations which have the greatest impact on small businesses; and to explore policy recommendations addressing "unfair" competition. After attending the hearing conducted by the Committee, we believe that neither NIB nor sheltered workshops are targets of the concerns raised by and the various policy changes proposed by small business advocates. However, we are submitting written testimony to explain the role of nonprofit sheltered workshops in providing employment to the nation's blind and severely handicapped citizens.

B. BACKGROUND INFORMATION:

Of the estimated 900,000 nonprofit organizations in the United States, about 5,400 are sheltered workshops and only about 115 specialize in serving blind and multihandicapped blind persons. In addition to being a small segment of the nonprofit community, these organizations are unique and different from other nonprofits. Since the sheltered workshops and the work they perform is not generally well known, we are taking the liberty to describe it in some detail.

1. DISABLED PEOPLE:

Disabled persons, like other Americans, do not form a homogeneous group with identical capabilities, needs, and requirements. To understand their employment potential, one must take into account factors such as their abilities and limitations (if any, imposed by the disabling condition) compared with job requirements, education, qualifications and training, accommodations and supportive services needed, job opportunities, attitudes of potential employers and coworkers, availability of affordable technology, job discrimination, and others.

To understand their employment potential, disabled persons can be divided into three broad categories with many individual exceptions. There are many disabled people who possess at the most, only a limited handicap for the job under consideration and who are capable of obtaining and holding employment in private industry, after receiving necessary rehabilitation services, without any governmental or private assistance. They require only minimum job modifications and little or no supportive services to function in the competitive job market and to perform at normal levels of productivity. As a result, any added cost of employing them is limited. At the other extreme are disabled people, some of whom are institutionalized, who, under the current circumstances, either simply cannot work or cannot be employed at the present time, based on currently available and affordable technology, in view of the severity of their disabling conditions and/or the extent and type of modifications and supportive services that would be needed to enable them to obtain and hold employment. The added cost of employing these individuals is prohibitive and beyond the capability and/or willingness of industry and even beyond the capability of some workshops. In between these two groups are disabled individuals who either cannot obtain and hold employment in the competitive labor market but who do have the ability to be employed in sheltered workshops on the basis of necessary job modifications and supportive services or who prefer sheltered employment. Within this group, even after such modifications, there are those that tend to have less productive capacities due to their disabling conditions. The added cost of employing them is beyond the ability or willingness of most competitive employers. On the other hand, the sheltered workshops are willing to hire them because serving such persons is their primary purpose.

Industry, including small businesses, is often willing and able to hire disabled persons from the first group since they require very minor or no job modifications and supportive services. Unfortunately, industry is either unwilling or unable to make the necessary job modifications or provide the needed supportive services to employ severely disabled people. These statements are supported by a recent survey of disabled individuals conducted by Louis Harris and Associates (Study #854009 dated March 1986). Sheltered workshops, including those associated with NIB, are organized to serve those disabled persons not otherwise served by industry. In fact, the Javits-Wagner-O'Day Act (JWOD), discussed below, generally limits its benefits to this group of individuals that are not being or cannot be served by government and industry.

Small business, which accounts for over 50 percent of the nation's employment, has created two-thirds of all new jobs in the nation according to a recent study. For this, they deserve credit. However, according to the Louis Harris survey referred to above, the unemployment rate for disabled persons is currently 66 percent in contrast to just over 5 percent for the general population. It is clear that neither small business, government, nor industry in general, has created sufficient employment opportunities for disabled persons either because of higher costs, needed job and tooling modifications, or supplemental support services. This is where sheltered workshops come in and provide such employment opportunities because they are organized and equipped to take on the additional responsibilities of employing disabled persons who require supportive services.

2. SHELTERED WORKSHOPS:

Sheltered workshops that provide employment and related services to blind people in the United States were generally considered to have started with the first program in 1842 at the Perkins School for the Blind in Watertown, Massachusetts. Although the Perkins School was graduating blind young men, they were unable to find employment. Society at large, including industry, simply did not recognize that blind people could be productive citizens. In order to provide some type of reasonable employment and a measure of self-sufficiency, the Perkins School was forced to start its own employment program. The program was later expanded to provide jobs for other blind people in the greater Boston area who were not graduates of the Perkins School.

In the following decades, concerned citizens and other schools for the blind began to realize the almost totally unmet need of jobs for blind people. More workshops, therefore, were begun in major metropolitan areas. The primary mission of these workshop programs prior to 1938 was clear-cut: provide an opportunity for self-sufficiency through productive work, because no one else would. Much of the work done in these initial workshops involved simple handicraft items, chair caning, basket weaving, broom making, and needlework. Products were sold to the general public, commercial firms and government agencies, but most often on a sporadic basis. The result was intermittent employment followed by extended periods of inactivity for many blind people.

In 1938, at the urging of leading blind citizens and workshops for the blind, Congress passed the Wagner-O'Day Act with the purpose of providing a steady market for workshop products and, therefore, steady employment for blind persons. As sheltered workshops grew, other unmet needs of blind people were recognized. Additional services related to independent living were developed so that some blind persons would not remain a burden on their families or community. As more services were added, workshops evolved into multi-service organizations which could address the needs of the whole person.

Increased efforts were made to open competitive sector jobs for blind people through demonstrating their capabilities to industry and society alike. This involved constantly searching for more complex products requiring market relevant skills which could be adapted for manufacture by blind persons. As a result of these efforts and increasing acceptance by industry, more and more blind people were able to obtain competitive employment, thereby freeing workshops to concentrate on those multihandicapped blind persons who were previously considered to be unemployable. As a result, the proportion of multihandicapped blind persons employed by the workshops has increased steadily from 9 percent in 1968 to almost 50 percent in 1987 with mental retardation and severe hearing loss as the most prevalent secondary disabilities.

Sheltered workshops serve a social function by catering to the most severely handicapped, a priority repeatedly urged by Congress itself. In order to employ the targeted group of handicapped persons, sheltered workshops must necessarily provide a wide range of habilitation, rehabilitation, training, accommodation, placement and supportive services. Some of the services provided and special accommodations made by sheltered workshops are:

* Pre-vocational and vocational evaluation
* Orientation, mobility and independent living training
* Flexible hours and part-time employment
* Transportation
* Psychological counseling
* Work adjustment
* Extended training programs, on-the-job training
* Matching jobs to individuals
* Rehabilitation engineering
* Job modifications such as breaking down tasks into simpler components
* Special jigs and fixtures
* Redesigning workplace/appropriate light and color
* Special work stations
* Modifying equipment and tooling
* Provision of additional equipment, tooling, and supervision to account for less than 100 percent productivity
* Upward mobility to indirect labor and supervisory or management positions
* Competitive placement services

3. JAVITS-WAGNER-O'DAY ACT:

The original Wagner-O'Day Act was signed into law by President Roosevelt on June 25, 1938. It was designed to create additional employment opportunities for blind people by requiring the government to purchase selected commodities produced by workshops for the blind. Participation in the Act was limited to nonprofit agencies with at least 75 percent legally blind direct labor hours in the production of commodities. The Wagner-O'Day Act was amended in 1971 as the Javits-Wagner-O'Day (JWOD) Act to permit participation by workshops serving the other severely handicapped and to include the provision of services in addition to commodities in an effort to further expand employment opportunities. The term severely handicapped was defined in the Act itself as "persons under a physical or mental disability, which constitutes a substantial handicap to employment and is of such a nature as to prevent the individual from currently engaging in normal competitive employment". Once again, participation in the Act was limited to nonprofit agencies employing at least 75 percent legally blind or other severely handicapped hours in direct labor. Thus, the government program was designed for and limited to the targeted group of blind and severely handicapped individuals most in need of such assistance.

4. SHELTERED WORKSHOPS - SOURCES OF REVENUE:

The 5,400 sheltered workshops in the United States serving over 260,000 blind and handicapped workers depend upon a variety of revenue sources, including most of those listed in Internal Revenue Service (IRS) Form 990, Part I. However, the proportion of each sheltered workshops' gross income from each of these sources varies widely. Some sheltered workshops endeavor to generate, as a matter of policy, most of their income from the sale of goods produced and services provided by handicapped workers, in keeping with the spirit of self-help for which they were created. A few are legally prevented from raising funds by state statute or by their charter or bylaws. Others are able to supplement their income, derived from selling goods and services, through fund-raising activities, either on their own or through community organizations such as the United Way. Some have significant endowment income, while others have little or none.

The 83 agencies for the blind currently associated with NIB representing 107 sheltered workshops are operated by Boards of Directors or other governing bodies. There is a wide variation in sources of gross revenue among the agencies for the blind, particularly since some of them are full service rehabilitation agencies, while others are primarily sheltered workshops providing an employment service. In many cases, private and public charitable giving has provided the base for the parent agency service programs, whereas the workshops have relied primarily on the sale of goods and services resulting from the employment of blind workers.

It is important to note that this is another factor that makes sheltered workshops unique. Some have indicated that nonprofits, over the years, have relied increasingly upon the sale of goods and services and less and less upon donations. However, the revenue sources for sheltered workshops have generally remained unchanged over at least the past 50 years since the original WOD Act was passed.

The net income, if any, that sheltered workshops receive from the sale of goods and services is considerably less than that of for-profit businesses engaged in similar activities because the workshops' costs of production are appreciably higher. Thus, often losses occur which must be made up by donations. Where a net margin is realized, it, of course, cannot be utilized for the benefit of any individual and is commonly used for providing additional services to blind and severely handicapped persons.

C. ISSUES:

1. UNFAIR COMPETITION:

NIB believes that while sheltered workshops may compete with small businesses in a limited sense, they do not compete unfairly. The goal of small businesses is maximizing profits, whereas for sheltered workshops it is increasing employment and related services for handicapped persons. Therefore, they do not vie for a common "prize" and thus cannot be said to "compete" directly with each other. In fact, NIB would like to see increased competition between for-profit businesses and sheltered workshops in the hiring of blind and handicapped workers.

Because of their defined mission and the people they serve, sheltered workshops deliberately limit their ability to compete with industry. For example:

* At a time when most industry is improving productivity through automation, sheltered workshops find it difficult to automate because it could mean a reduction in handicapped employment.
* Unlike industry, sheltered workshops do not export jobs to foreign markets to take advantage of cheap labor or move to another community to take advantage of market conditions, availability of workers, lower wages, or tax benefits. They must remain where their handicapped workers reside.
* Sheltered workshops have limited capital resources and access to both government and commercial loan sources.
* Sheltered workshops cannot attract the top-notch graduates from business schools and colleges and universities because of modest salaries and limited opportunities.
* Sheltered workshops must develop specially designed work stations and equipment.
* There is a need for additional job training, rehabilitation and supportive services in sheltered workshops.

Section 14(c) of the Fair Labor Standards Act which applies to both sheltered workshops and to businesses, permits payment of less than minimum wages to disabled people in order to prevent curtailment of employment opportunities. The workers must still be paid wages commensurate to those being paid non-handicapped persons for essentially the same quality and quantity of work.

This means that for an identical method used, the per-piece rate is the same for handicapped as well as the non-handicapped person. However, beyond the wages themselves, the employer serving blind and handicapped individuals must make necessary modifications to the job and workplace, provide additional equipment, tooling, and supervision to account for those unable to achieve 100 percent productivity and provide the necessary support services previously described. Therefore, the total cost of wages, fringe benefits, and supportive services furnished for every piece produced are significantly higher than those for non-handicapped workers. If this were not true, commercial industry would be rushing to hire this group of handicapped persons to benefit from the supposedly lower costs of production. Although sheltered workshops are willing to accept such higher cost based on their mission, they would be happy to relinquish it, if it results in competitive employment for blind and handicapped individuals.

Some advantages possessed by small businesses are difficult to quantify. For example, what are the intrinsic advantages of working with a productive, non-handicapped work force that does not require a great deal of adjustment, training, accommodations, supportive services, etc.? It could also be argued that federal statutes give special advantages to small business not enjoyed by sheltered workshops. The Small Business Act provides a set-aside in government contracts; sheltered workshop federal contracts are even less than one percent of the total of those received by small business. And we wish to point out that in the past NIB has been reluctant to support proposals to permit sheltered workshops to participate in the small business set-aside program -- we are willing to make it on an even playing field. Sheltered workshops do not receive the technical assistance, opportunities for guaranteed loans, and the entire range of services provided by the Small Business Administration to benefit small business.

Several studies by impartial government agencies and others have demonstrated that sheltered workshops do not enjoy a competitive advantage over small businesses. Prompted by complaints from a few small businesses, the General Accounting Office (GAO) conducted a detailed study (HRD 81-99 dated September 1981) of sheltered workshops and any competitive advantage they might possess. The GAO found no proof of competitive advantage for sheltered workshops. Similarly, continuing oversight of sheltered workshops participating in the JWOD program by Congressional Committees has never raised the issue of unfair competition with industry. In fact, Congress has recommended that more federal agencies and Congress itself should be buying under the JWOD program. Finally, a 1986 study by the Santa Fe Corporation, an independent consulting firm, found that the competitive advantage, if any, really belonged to small businesses and not to sheltered workshops.

2. COMMERCIAL ACTIVITIES:

SBA has suggested establishing a ceiling on so-called "commercial" activities of nonprofits. Others have suggested that nonprofit organizations should not engage in "commercial" activities that are also provided by one or more for-profit businesses. The definition of "commercial" activities adopted by small businesses appears to include any activity that has a value in the marketplace and, as such, is either currently performed by for-profit businesses or could be performed by them in the future. Under this definition, any manufacturing or service activity by a sheltered workshop would automatically be considered a "commercial" activity.

There are fundamental problems with this definition because it ignores the purpose for which the alleged "commercial" activity is carried out and the manner in which it is carried out. In our opinion, true "commercial" activities have a fundamental goal of maximizing profits and as such, are carried out in order to either reduce costs or maximize profitability.

There are significant differences between for-profit businesses and sheltered workshops. Businesses select the product to be manufactured on the basis of market research to ensure high profit margin, low competition, and high demand. The manufacturing process and equipment are chosen on the basis of lowest production costs while meeting quality and delivery requirements. In some cases, this could mean total automation of the manufacturing process resulting in the elimination of most labor, or even producing the item abroad. The company then attempts to hire the most productive workers it can find at the lowest wage rate. Such highly productive workers are retained while the unproductive workers are either not hired or terminated at the earliest opportunity. After the start of production, the business is constantly searching for further cost savings through redesign of the product, changes in the process and equipment, and other actions. If necessary, the production of that item is discontinued to concentrate on a more profitable item or the manufacturing process shifted to a foreign country to reduce labor costs.

In contrast, a typical workshop for the blind associated with NIB selects a product for manufacture under the JWOD Act with the primary goal of maximizing the employment potential for blind persons. Any products lacking adequate employment potential are considered to be unsuitable for production under the JWOD program. Equipment and processes are selected in order to increase the available labor hours. Moreover, workers are generally employed on the basis of their lack of capability to engage in or locate competitive employment. Typically, many such workers require substantial training, accommodations, and supportive services to improve their productivity, which is one reason they have not been hired by the for-profit businesses. NIB even encourages its associated workshops to open up Work Activities Centers in order to hire multihandicapped blind workers whose productivity is considered "inconsequential". The jobs, equipment, and tooling are all modified to match the workers' abilities and limitations, and training and necessary supportive services are provided to permit them to continue to work. In addition, every effort is made to promote upward mobility or to place the most productive workers outside the sheltered workshop in competitive industry so that the workshops can redirect themselves to serving others with lower productivity.

It is clear that sheltered workshops produce and sell goods and provide services primarily for the purpose of creating employment and not for maximizing profits. Their specific decisions regarding product and equipment selection and the hiring and promotions of workers are consistent with their mission and actually increase production costs rather than maximize profits. In fact, it can be argued that if the workshops' goal is to engage in "commercial" activities, they are going about it the wrong way.

Finally, it should be emphasized that such "commercial" activities of sheltered workshops have been repeatedly encouraged and promoted by federal and state governments through a variety of laws and regulations.

4. EARNED INCOME CEILING:

One of the recommendations by SBA and certain small business advocates is to limit the income from "commercial" activities that nonprofits would be permitted to earn before their tax exemption is revoked. As stated above, sheltered workshops in general, and those associated with NIB in particular, depend on the production and sale of goods and services in order to fulfill their basic mission of providing habilitation, rehabilitation, training, employment, placement and supportive services to the handicapped persons they serve. A ceiling on earned income will force sheltered workshops to curtail such activities and depend more on fund raising activities. Such dependence on charity is contrary to the spirit of self-help that sheltered workshops have adopted and are trying to instill in the handicapped persons they serve. NIB believes that any restrictions on self-generated income will simply penalize those handicapped workers who prefer to be self-reliant and reward those who depend on charity.

D. POLICY CONSIDERATIONS:

The purpose of granting tax exemption has always been to encourage certain activities that are considered to be of great interest and usefulness to the nation and society. The key question that the Committee must ask is, "Is government and private industry capable of adequately providing the services currently provided to blind and handicapped persons by sheltered workshops?"

NIB believes that promoting the employment of the targeted group of blind and handicapped persons and providing them with needed habilitation, rehabilitation, training, placement and supportive services is certainly a purpose that deserves the encouragement of Congress through tax exemption. Industry appears unable to provide adequate employment services for handicapped persons (as clearly indicated by an unemployment rate of 66 percent), in spite of the special tax advantages offered to them for hiring such persons. If, in the distant future, this exempt purpose no longer appears to be in the national interest, or if government and industry emerges to provide needed services to all blind and handicapped people in adequate quality and quantity, then Congress should certainly, at that time, consider withdrawing tax exemption.

The federal government has had a long-term, ongoing commitment to creating and promoting employment opportunities for blind and handicapped persons through programs such as the Randolph-Sheppard Act, Sections 503 and 504 of the Rehabilitation Act, and the Fair Labor Standards Act. If the Committee were to reverse this by restricting the production and sale of goods and services by sheltered workshops, Congress will be sending contradictory signals to handicapped people and to the nation. Encouraging handicapped persons to become self-sufficient, taxpaying citizens through programs such as JWOD, is a laudable goal.

In a sense, this entire debate is about "opportunity" and "fairness". The small businessman seeks nothing but an opportunity to compete fairly and to make profits. He is willing and able to devote himself, take chances, and build his business through hard work and long hours. NIB salutes the small businessman and we wish him well. Congress should ensure that he is given that opportunity. On the other hand, blind and handicapped workers served by sheltered workshops, seek nothing but an opportunity for a meaningful job, an opportunity currently denied to them by industry. They are willing and able to prove to themselves and others that they can be self-supporting, taxpaying citizens. We believe Congress should do no less for them.

E. RECOMMENDATIONS:

1. In it deliberations, we urge the Committee to keep in mind the unique role of sheltered workshops in providing gainful employment to the targeted group of blind and severely handicapped individuals, some of whom otherwise may remain idle and dependent on public funds, or their families, or remain institutionalized.

2. The commitment of federal government to creating and to promoting employment of blind and handicapped persons is well established. We urge a stepped-up effort with built-in incentives for industry to employ the handicapped in rough proportion to their numbers in the working age population.

3. NIB strongly disagrees with the suggestion by SBA and certain small business advocates that a ceiling on "commercial" activities of nonprofit organizations be adopted, since this will prevent sheltered workshops from performing their basic mission.

4. Regardless of any decision about a ceiling on the "commercial" activities of nonprofit organizations, NIB strongly urges the Committee to exempt all nonprofit organizations participating in the JWOD program, along with all other sheltered workshops, so that they can continue to provide employment services to blind and severely handicapped persons.

5. NIB believes that the current unrelated business income tax laws and regulations are reasonable but should be better-enforced to eliminate abuses. Congress can improve IRS enforcement by clarifying some of the ambiguous terms. However, like the Treasury Department, NIB believes that the relatedness standard is a valid test and must be retained. IRS should provide clear guidance to reduce unintentional non-compliance with the law.

TECHNOLOGY PARTNER'S TESTIMONY ON UNFAIR COMPETITION

The following testimony is being presented to The United States House of Representative's Committee on Small Business.

My name is Thomas E. Diroff and I am the owner of Technology Partners Inc./ Todays Computers Business Center.

OVERVIEW

The computer industry in and around Ann Arbor, Michigan has not been decimated, yet, by the University of Michigan's (U/M) computer selling activities due primarily to a still expanding market. The U/M activities have stunted the growth of the industry overall and weakened the ability of the 5 major dealers to survive long term.

The U/M uses a highly biased campaign, their "non profit" buying advantages and a considerable ability to shift resources to attain its massive sales. In 2 days of selling it becomes the largest computer dealer in Ann Arbor by approximately 100%. By becoming a reseller and employing its chosen tactics the U/M has violated a public trust to provide unbiased information.

The small business community as a whole, not just computers, is being downtrodden by the U/M's predatory and self serving activities. The entire community, business and consumer, of the Ann Arbor area is not attaining any where near the potential benefit that a large institution like the U/M should be providing.

The activities of the non profits must be scrutinized by a review panel **BEFORE** they are allowed to proceed if small business is to survive and grow.

TECHNOLOGY PARTNERS TESTIMONY ON UNFAIR COMPETITION

TECHNOLOGY PARTNERS HISTORY

Technology Partners was founded in 1982 as a 1 person company in my parent's basement. It currently employs 33 full and part time people and will soon occupy a 10,000 square foot building. (We moved out of the basement in 1983 much to the relief of my parents).

The "partner" in Technology Partners is reference to how we view the relationship with our customer and the philosophy that our product is customer satisfaction with computers being only a means to the end. We try to make customers, not sales.

When we started, the U/M (departments, staff, etc) was our only customer and we grew via word of mouth, fair pricing, and good service. We were told by the U/M accounting department that we were the ONLY firm that would invoice the U/M at reduced prices, when compared to the purchase order amount which they had committed to pay. We did so because we always tried to pass cost savings to our customers and as part of our commitment to a long term relationship, we saved the U/M tens of thousands of dollars.

In 1985 we purchased a Todays Computers Business Center franchise which, among other things allowed us to become an authorized dealer for IBM personal computers.

In late 1986 we were forced to dramatically reduce our business relationship with the U/M, (we refused departmental P.O.'s for anything but repairs and complete system sales) after analysis had strongly suggested that we would be driven out of business by U/M tech support requirements. This drastic action was the result of an ever increasing U/M involvement in computer sales. Over time the volume of certain products increased and the U/M sought to buy at better prices which they defined as "cutting out the middleman and buying direct". There were some purchase arrangements that we were not allowed to bid on because the U/M only wanted lowest price and assumed that only manufacturer direct buying could provide that. We and other dealers, were put in the difficult position of introducing a good product to the U/M and supporting it so the demand would grow, only to be discarded when the volume shipments began. More importantly, we found that while the sales declined, the number of pre- and post sales technical support calls continued to increase and we ended up giving away a lot of free support in order to maintain our reputation. The calls came to us for 4 major reasons:

1) We had a reputation for being knowledgeable.
2) Our information was not biased to selling only our products but rather the best product for the customers needs.
3) The U/M "support" people did not offer #1 or #2.
4) We were close and a local phone call away.

We were forced from the U/M marketplace in order to preserve the company.

In order to survive we have concentrated on selling IBM compatibles which offer better price and performance than those which the U/M offers. Our IBM business and that of other dealers in town is almost non existent, especially to individuals and small businesses. We are the only major dealer in town to concentrate so heavily on these clones.

In 1987 our sales were $3.7 million and we estimate $4.5 million for 1988. Our net income for 1987 is approximately $100K which is a bit misleading since my draw is only $5.00/hr.

In 1982 our product mix was almost 100% peripherals and no computers. Now however, the mix is reversed to 90% computers and 10% peripherals.

THE COMPETITIVE ENVIRONMENT

a) 5 "Major" computer dealers are authorized to sell some, or all of the brands of computers that the U/M "sells". All of these dealers operate at "B" level pricing ("C" level is the best discount and represents about a 7% savings). Estimated annual revenues of the stores are $2 - $5 million each. These five stores were in existence in one form or another when the U/M started its selling activities. One store shrunk from 3 locations to 1. Persistent rumors have 2 stores very close to closing or changing ownership due to financial problems.

All 5 dealers rely on volume sales to survive.

b) There are at least 15 dealers of other computer products ranging from basement operators to mass merchandisers. Virtually every one has computers that are "clones" of the ones that the U/M offers. Revenues are very difficult to estimate.

Recently, there was one closing of a dealer in this category.

c) There are an estimated 100 other area businesses that will provide computer products but whose emphasis is more on total support for their customers software application.

d) The biggest dealer, the University of Michigan conducts 1 major sellathon a year, the Computer Kickoff, and grosses $9 to 10 million for the 2 day event. It also provides a year-round program to allow students, staff, and faculty to purchase computers at significant discounts that are usually at or below the dealers cost. The U/M also provides computer equipment to private companies who retain "agency" status due to their U/M heritage. The computer equipment provided to this last group of customers is significant due to their technical nature and consequent high usage of computers.

The U/M primarily sells Apple, IBM and Zenith computers. They also sell peripherals like dot matrix printers (Apple, Epson, Citizen), Laser printers (Apple, Hewlett Packard) modems until recently (Racal Vadic), supplies (diskettes, paper, cables), and software (Microsoft Word). The year round program also sells supplies (diskettes, paper, cables) and until recently modems (Racal Vadic). See Appendix A.

The U/M is the largest employer in the area.

The U/M's stated pricing policy is cost recovery.

U/M EFFECT ON COMPUTER BUSINESSES

The U/M's sales have not had a fatal effect on the 5 major stores, yet, primarily due to a still expanding computer market. There are enough table scraps to survive.

Certain product sales have been severely depressed or effectively eliminated. These products are IBM and Zenith computers and Microsoft Word. The lack of IBM sales is potentially fatal since IBM has imposed sales quotas that, if not met, will result in the loss of our IBM franchise. IBM has notified us that we are under review for not meeting our quota.

The used computer prices are depressed. Two attempts to run an used computer store have failed.

The price for computer literate labor is elevated due to the U/M hiring level and the price they are willing to pay. "Talent" that most stores could not justify at $15,000.00 /year, the U/M seems to pay $25,000.00.

The businesses with a store front have a higher cost of doing business due to the large number of technical support questions that they are bombarded with from U/M buyers, without a chance of getting the sale. One store abandoned a phone number in a full page yellow pages ad because it was close to campus and was they were being overwhelmed with calls.

The U/M has effectively restricted the growth of small computer stores into larger businesses by not allowing the U/M's volumes to have a synergistic effect, as well as reducing the effective market place.

COMPETITIVE COMPLAINTS

I) The U/M restricts competing dealer sales of computers into the student, staff/faculty and departmental market.

There are 3 basic type of computers that can be sold into this market:

a) Identical IBM, Apple and Zenith computers to those that the U/M provides.

These sales are almost non existent since the U/M sells at prices that are below normal dealer costs. The only competitive feature we have is quicker delivery. (see Appendix D).

b) Clones of the above (Eg. Compaq, AST, generic).

These products can offer better price, performance, and service than those the U/M offers, but the U/M builds severe barriers to these being sold since they don't have the "UNIVERSITY SUPPORTED" label. Appendix B details the "UNIVERSITY SUPPORTED" criteria. This label is a tremendous barrier to overcome and despite requests, the U/M has made no effort to define the technical criteria or any process to certify dealer equipment (even at dealer expense). In reality some U/M chosen equipment has been shown to be far less compatible than the cheapest Taiwanese import.

The other key issue with the supported label is that if an end user, who has purchased all items from the U/M except one, asks for help from the U/M support staff, they are likely to be told that NO help is available since that one item is not "University Supported" and the "consultant" has no knowledge. The truth is that all real computer dealers are able to help the end user, if they want to, since most problems are pretty basic and most computer software and hardware have the same basic principles. Manufacturers like IBM will routinely send non IBM product tech support questions to their authorized dealers. The problem for the dealer who sells that one "non supported" part is that the dealer must now take support responsibility for the whole system, if they want to help the customer. The U/M is able to get away with saying no to the customer but dealers who rely on a good reputation can not.

c) Machines that provide the same function (Eg. Commodore, Amiga).

This is almost an impossible sale. The U/M has never provided any basic information regarding what the computer must be capable of doing in the U/M environment, so both the dealer and the prospective buyer are at great risk. I have verified this with the local Commodore specialist.

Also key to the competitive barrier is that the U/M "bundles" Microsoft Word with every IBM like system at the Computer Kickoff. Microsoft offers this to the U/M at $50.00 where the normal wholesale price is about $180.00; our dealer cost is around $200.00 per copy. This cost difference makes some dealer configured systems look even worse when trying to compare price. The buyer could buy Microsoft Word separately from the U/M (for $71.00) but the U/M doesn't make that widely known.

II) The U/M restricts the ability to sell peripherals, and the sales that result are not very profitable.

When the U/M started their sales effort, U/M officials indicated that it would open a great market for computer add-ons. At first the U/M only sold computers and the previous statement was true, but, over the years the U/M found it "necessary" to expand, so that now they offer complete packages including software and printers and virtually everything that a person needs to have to get started. They offered modems up until very recently in their year-round sales effort.

There is also the problem that peripherals are deceptively costly to sell and can be ultimately unprofitable. The time it takes to sell a peripheral can be equal to, or exceed that of, selling a computer system and result in a lower contribution to revenue due to being a smaller ticket item. More importantly is that when you sell a peripheral, and it does not work, there are many times when the problem is not the peripheral but rather something in the rest of the system. However, the customer perceives the problem to be the dealer's responsibility since what we sold appears not to work. We have lost a tremendous amount on this problem.

About 2 years ago the U/M was selling the Zenith 158 which along with being poorly constructed had absolutely terrible IBM compatibility problems. Products that would work perfectly in true IBM computers and even the cheapest Taiwanese clone, would not work in the Zenith. We incurred so much ire from customers, even though we demonstrated that our product would work in the real IBM machines, that we instituted a special Zenith policy that we would guarantee the product to work in every respect, except in a Zenith. To my knowledge the U/M never made any effort to make buyers aware of the Z158 problems.

III) **The U/M is providing biased information to its students, staff and faculty members which violates a sacred trust and simultaneously prevents other products from being considered for use.**

Buying a computer is a complex decision and most people lack the knowledge base or inclination to investigate thoroughly enough to make a well informed decision. Therefore, buyers have to rely on the integrity and/or the accountability of the seller to provide the buyer with the best solution.

The U/M selling method is oriented to providing customers with a prepackaged solution and explicitly or implicitly indicating that only that particular solution will work for the end user's job. I had a friend that walked into the consulting area and asked about purchasing a modem so that she could do work from her home. She was told that she needed a Racal Vadic modem and that she could purchase it from a certain location on campus. The truth is that any number of modems work fine but she was not given any indication of ANY other possibility. I object to this for 2 major reasons:

a) **The U/M is using its "educator" status and the unquestioning way that we have to accept the information it provides in the classroom, to sell its products. This is a very dangerous violation of the public trust and has potential long range problem, that makes the computer sales miniscule by comparison.**

You can start to see the problem by looking at the types of computers being sold in the "real world" compared to that at the U/M. A recent nationwide survey indicated that for the second quarter 1988, IBM and IBM like machines held a 87% to 13% market share over the Apple MacIntosh in the business world. Yet the latest numbers I received for this years Computer Kickoff indicated Mac sales to be 73% of the total. Last year when the Mac had even less presence in the business world the U/M mix was 50% MAC. I would expect that the sales would approximate those of the "real world" but that is not the case. (Certainly the U/M will make the case that the MAC is better for their academic environment, but what good does it do to train students to survive in an academic environment when the rest of their life will be in the real world?)

b) **It limits the sale of better products as the result of customers not knowing that the alternates will work and it greatly reduces the desire to even look for an alternative.**

The U/M's Computer Kickoff program is designed to induce people to buy at this event rather than as the result of an examined need. The Kickoff prices show "% savings" when compared to retail prices. See Appendix D. In reality, retail prices are almost always significantly lower. Further, if the buyer were told the truth, they could always purchase from the U/M's year-round program at prices similar to Kickoff prices. I was told by U/M people that there was a survey done at last years Computer Kickoff that indicated that people were buying computers at that time because of the event. I think that it is wrong for anyone to induce people into buying at anytime but for a University to do it is alarming and inexcusable.

IV) **U/M is able to sell at such low prices because it isn't covering all it costs or it is not subject to the same expenses as a regular business. The U/M has access to special product pricing apparently available to them under the Non Profit Institution Act of 1938.**

I firmly believe if the U/M were truly accountable for its computer sales as a full service dealer has to be, they would lose massive amounts of money at the current price level, and in order to break even, would have to charge almost as much as other dealers do, even with their better buying arrangements. I also believe that the U/M people will swear to and provide paperwork to prove that they are not selling below cost. The only way to be subtle is to do a complete audit (which they will fight) and examine their assumptions compared to a regular dealer. The relevant information that I have to offer are:

a) I briefly examined an income statement from the 1987 Kickoff event and from the explanations given ONLY variable costs directly attributable to the sale were expensed. There were no cost for : support people to answer post sale questions; service people to fix broken equipment; investment in spare parts to speed broken equipment repair. There is a copy of the income statement for the 1987 Computer Kickoff provided in Appendix C as well as an accompanying article indicating that over 300 people participated in running the event.

The income statement shows that approximately $110,000.00 of labor cost was incurred.

There is a position at the U/M, Microcomputer Sale Program Manager which pays $42,528.00 annually.

Another key person in the sale makes $39,628.00 annually although this person is not totally dedicated to micro sales as the previously mentioned person.

There are another 298 people that participated.

The U/M has 47 fulltime and another 22 fulltime equivalents in their micro computer support staff (according to a posted U/M printed article). In reviewing the published salary information the average salary for the lowest level consultant is $25,000.00, which translates into at least a $1.725 million annual labor expense for just this one entity.

b) The U/M can shift funds to help a new venture get started and virtually guarantee no risk of failure. Last year's Computer Kickoff showed a profit of approximately $10,000.00 but what would have happened if it lost $10,000.00? I doubt that anyone's salary would have been reduced!

The purchase and sale of Microsoft Word at the ridiculously low prices detailed above (U/M cost $50.00, ours $200.00) is apparently protected under the Non Profit Instituion act of 1938 and gives them a tremendous advantage.

V) **The U/M allows the distribution of its computers to be too large, by design, and by inadequate policing actions.**

The current U/M program allows sales to students, staff and faculty. The inclusion of sales to staff members (Eg. cafeteria workers, custodians, etc.) exceeds any normal rationale for an "educational" goal.

The U/M allows companies that used to be part of the U/M, but are now private companies, to purchase products including computers. Known companies include ERIM (Environmental Research Institute of Michigan) and ITI (Industrial Technology Institute). The companies represent large volume as they are technical in nature.

Dealers have always complained about computers sold at the U/M being either then sold to other non U/M personnel and companies, or used by related family members for non U/M educational activities. The U/M imposes a $2000.00 liquidated damage to anyone caught violating a "no sales" agreement, which must be signed before receiving the equipment, but it is not very well displayed and the U/M has no incentive to enforce it. In the past when presented with this claim, the U/M has promised that any dealer discovered abuse will be prosecuted. However, this makes the dealer responsible for policing the U/M's own program and furthermore places the dealer in a no win situation. Lose because the dealer turns in a customer, as is the normal way to come in contact with a violator, and lose because the dealer would appear as the "bad guy" for trying to "nail a poor individual". In addition, it is not clear that the individual is truly the only one at fault due to the U/M's failure to really publicize the importance.

One local dealer just reported that he received a call from a local business that wanted a quote on 4 IBM Model 50 Z's. The caller indicated the price had to be good since he had 4 students lined up to pick up computers at the Computer Kickoff (10-14/10-15).

Dealer estimates of the abuse range from 20-50% of all systems sold, based on the number of people who come in for information but don't buy because "they have a friend at the University". In a January meeting with U/M people, I offered to produce a list of violators on the condition that it be for verification of the problem and not prosecution. The offer was refused and I was accused of being a "co-conspirator". In this year's Computer Kickoff booklet the U/M has slightly improved the wording so that IF people read the entire booklet they should be more aware, but even this is not enough. Other suggestions that I presented were rejected as being "too expensive". It is typical that small business is left to incur the cost. See Appendix E.

VI) Private industry can provide the computer power that the U/M needs but, never will be allowed to , because the U/M is able to define the problem in such a way that only they are able to provide a solution.

It was stated to me that the U/M's objective is to provide the lowest cost computing to the student.
- The U/M defines cost as the purchase price which is arguably not the true "cost" that the buyer should pay to provide the functionality that they think they are buying.
- When the U/M is presented with a non IBM, Apple Or Zenith computer that is better priced they suddenly insist that ONLY the computers they have chosen are acceptable. Some of their reasons are valid but all can be dealt with if the issue is examined rationally, however there is no incentive to do so. Clearly, if the U/M can specify only brands on which they have arranged special deals (using the Non Profit Act?) they will forever be involved.

U/M's GENERAL ATTITUDE TO SMALL BUSINESS

The fundamental truth that you have to realize is that the U/M's #1 goal is the survival and growth of the U/M as an entity. Everything else, including education is secondary. As such, the U/M is only interested in "partnerships" from which it can benefit, regardless of the benefit to the other "partner". The U/M only understands receiving, it does not know how to give, or to reach a compromise that is mutually beneficial especially, when the benefits to the U/M are not political, monetary, big, or immediate.

a) The U/M desires to work with big business rather than small business. This is because big businesses are perceived to be able to get better pricing and are certainly in a much better position to make "donations" to the University. There is no PR value (no Wall Street Journal articles) in signing a contract to do business with Technology Partners, but a deal with IBM can make front page news.

b) The U/M preference to big businesses hurts small businesses in that it allows big business penetration into a local market that otherwise would be too small or too distant to otherwise justify.

c) The U/M is very conservative and predatory in nature. It is quite content to let someone else establish a market before it steps in and takes it away. Local companies are most susceptible since their operations are closer and more visible. Additionally, products that are sold with service and support, the key factors for small businesses, are targets since the U/M can more easily compete on price.

d) Despite statements to the contrary, the U/M's effort to help small business is miniscule. See Appendix F for "what they say and what they really mean".

e) The U/M has a very strong "not invented here" attitude that causes it to duplicate the efforts with the private sector and within the U/M itself. Small businesses could grow tremendously and offer much improved services if these operations were farmed out.

VII) THE PUBLIC IS NOT REALIZING THE TOTAL BENEFIT THAT IS AVAILABLE AS LONG AS THE U/M IS INVOLVED.

A strong argument can be made that the consumer, either U/M affiliated or not, is failing to realize the full benefits that are available from a computerization effort like the U/M is undertaking.

* U/M affiliated*

a) The U/M customer never really has their needs examined closely.
b) The U/M product selection may have an initial low price but the buyer may incur larger than desirable repair bills throughout the life of the computer.
c) The U/M products may be obsolete or discontinued without being represented as such. The Citizen MSP-10 printer was offered at the last Computer Kickoff and still offered in the 9/88 sales literature, yet was out of Citizen literture, 11/87.
d) The U/M product choice may be based on political reasons rather than what best fits for the customer. Why choose Microsoft Word rather than the more popular Word Perfect software? Because the U/M has a volume comittment with Microsoft that must be satisfied.
e) Who can be held accountable if the consumer is dis-satisfied with their purchase?

* The rest of the community*

a) The community at large has always been the big loser, in my estimation, given that they pay taxes to support the U/M in part, yet are denied the opportunity to recognize some easily attainable benefits.
b) As stated before, volume is key to my business. When volumes increase I can expend more to provide better technical consulting support and even more importantly hardware repair services. Hardware repair is always overlooked and is the hardest to implement without the appropriate volumes. Test equipment, spare parts and trained operators are outrageously expensive and the Ann Arbor area is surprisingly deficient in this area.

The scenario is that as my volumes increase, I buy at more favorable prices or terms and then can decrease the prices I offer to all of my customers, including the U/M. If the U/M is able send their volume through my store, or other dealers, the entire community can benefit, not just one segment.

RECOMMENDATIONS

The problem is not computers, but rather the lack of respect for the needs of other people and entities. Legislation to make people respect each other and work together is almost impossible to imagine. As a second choice we must find a way to make the Non-Profit Orgainizations NEED small businesses and to make the "Non Profits" accountable for their actions so that the public good, as defined by the public, is really being met.

I do not propose an absolute restriction on Non Profit commercial activity because if I, as a small business, am not doing the appropriate job for the public, someone has to have the ability to step in. I also need to be held accountable.

I do propose that the Non Profits be prohibited from competing on price alone. That their offerings must be within 5% of an average local price.

I do propose that all "Non Profit" commercial activity be subject to the approval of a panel whose representation includes government and local business people. This panel approval must include some type of business environment impact analysis.

Thank you for your time.

Thomas E. Diroff
President
Technology Partners, Inc.

CIRCA 1987

APPENDIX A

THE UNIVERSITY OF MICHIGAN
PHOTO & CAMPUS SERVICES

COMPUTER PRODUCTS AVAILABLE FOR CASH SALE

The following items are available for cash sale through Photo & Campus Services

SUPPLIES:

3.5" Sony Disks (ss)	$33.70
3.5" Sony Disks (ds)	23.90
8.5" x 11 computer paper (1300 sts)	11.49
Imagewriter ribbon	2.95

ACCESSORIES:

Macintosh Security Kit	$30.00
Macintosh Plus Keyboard	99.00
Racol Vadic 1200 Modem	196.25
Racol Vadic 2400 Modem	415.80
MacPlus Personal Modem	285.02
Mac 128/512 Modem	285.02
1. MacPlus Accessory Cable 976210	15.00
2. #977895 Mac 128/512 9 pin cable	13.30
* 3. #977901 MacPlus 8 pin cable	17.00
#977883 IBM-PC/AT cable	8.95
#979235 IBM-PC/XT cable	9.75

* Zenith → Hayes

SOFTWARE:

MacProject	127.85
MacDraw	83.75
MacWrite	57.00
MacPaint	57.00
MacPascal	83.75
Switcher	8.00
Versaterm (Mac) 2.1	62.23
Microsoft Word ~~3.0~~ (Mac) 3.01	58.50
Microsoft Word 3.11(IBM) Both discs	75.00
Final Word II (IBM)	159.35

→ POP upgrade to 3.1

September 2, 1987

1. see picture
2. goes w/ A-25 pin
   B- Hayes
   C- Line driver
3. 8-25 pin

SUBLICENSED SOFTWARE:

PLEASE NOTE: WHETHER THESE ITEMS ARE PURCHASED BY AN INDIVIDUAL OR A DEPARTMENT, THE PERSON WHO INTENDS TO BE THE END USER MUST COME TO PHOTO & CAMPUS SERVICES, IN PERSON, TO SIGN THE USER AGREEMENTS.

Systat 3.0 (DOS)	74.00
Upgrade Systat 3.0 (DOS)	55.35
——old disks must be turned in—	
Systat 3.1 (Mac 512K)	94.60
Systat 3.1 (Mac 1M) + SE	94.60
Systat 3.1 (Mac Co-Processor)	94.60
Systat Upgrade for Mac from 3.0 to 3.1	25.00
——old disks must be turned in—	
Base/SAS 6.2 (PC-DOS)	52.00
SAS/Stat 6.2(PC-DOS)	39.00
V-Graph 2.20 (DOS)	15.50
Vedit Plus 2.03e	40.00
PAUP 2.4 (DOS)	17.00
PC TeX (without driver)	41.50
PC TeX & Epson FX Driver	74.10
PC TeX & Toshiba/Epson LQ Driver	73.00
PC TeX Epson FX Driver (only)	42.60
PC TeX Toshiba/Epson LQ Dr. (only)	41.50
PC TeX Apple Lazerwriter Dr. (only)	93.00
PC TeX Preview	63.20

'86

PUBLICATIONS:

Introduction to SAS	18.10
—includes Install. Instructions	
SAS Procedures Guide	17.95
SAS Language Guide	17.95
SAS/Stat Guide	17.95
Install. Instruct. & Tech Rpts. Only	3.95
PC TeX Manual	15.00

Computing Resource Center - The University of Michigan Computing Center

Video Components

Stores	Price	Description
	$165.00	Monochrome Monitor 8503
	$357.00	Color Monitor 8512
	$450.00	Color Monitor 8513
	$930.00	Color Monitor 8514
	$357.00	PS/2 Display Adapter for Model 30 (Provides VGA Video Capabilities)
	$930.00	PS/2 Display Adapter for 8514 /A For PS/2 Models 50,60,70,80 (This adapter is only required if advanced function graphics are needed. It can only be used with the 8514 monitor on the PS/2 Model 50, 60, 70 and 80.)
	$162.00	PS/2 8514 Memory Expansion Kit (For the 8514/A Display Adapter)
	$21.00	Display Stand for 8512

Software

Stores	Price	Description
	$84.00	DOS 3.3
978577	$71.00	Microsoft Word 4.0 (IBM Version)

Printers and Modems

Stores	Price	Description
	$357.00	Proprinter II 9 pin dot matrix, Requires Cable
	$479.00	Proprinter XL 9 pin dot matrix, wide carriage, Requires Cable
	$479.00	Proprinter X24 24 pin dot matrix, Requires Cable
	$829.00	Proprinter XL24 24 pin dot matrix, wide carriage, Requires Cable
978590	$186.00	Epson LX-800 9 Pin Dot Matrix Printer, Includes Tractor Feed, Requires Cable
978994	$210.00	Citizen MSP-10 9 Pin Dot Matrix Printer, Includes Tractor Feed & Cable
	$0.00	
	$0.00	

Supplies

Stores	Price	Description
976143	$14.25	Box of 10 3.5" Disks
663517	$8.22	Box of 10 360K Disks (5.25" DSDD)
663451	$15.29	Box of 10 1.2M Disks (5.25" DSHD)
976957	$7.82	Box of Paper
978381	$8.00	Printer Cable (For Proprinter, Epson or Citizen)
979235	$8.00	Cable: Modem to PC/XT and all PS/2 Models
977883	$8.00	Cable: Modem to AT/Z159
	$204.00	PS/2 Collegiate Kit (PS/2 Mouse, DOS 3.3, MS Windows 1.04, 4-Floppy Disks)

* = Price has changed from last price sheet.
Prices are subject to change.

COMPUTING RESOURCE CENTER
The University of Michigan Computing Center
3113 School of Education Building 764-5356

APPENDIX B

Prices for ***Individual*** Purchases — ***September, 1988***

IBM PERSONAL COMPUTERS

BUYING A UNIVERSITY-SUPPORTED MICROCOMPUTER

The University of Michigan supports the following microcomputers: the Apple Macintosh, the IBM Personal Computers, the Zenith Data Systems Personal Computers and the Wang Professional Computer. These computers were selected by the University's Computing Policy Committee because their capabilities and software meet most of the research, instructional and administrative needs of the campus. Departments and individuals affiliated with The University of Michigan are not restricted to buying University-supported microcomputers, but there are several advantages in buying systems from this list:

- The Computing Resource Center provides consultation and workshops on the supported computers, and provides hardware and software for evaluation.
- The Computing Center has developed or certified software which allows these microcomputers to be used as workstations attached to UMnet.
- The University has arranged special prices with the manufacturers of the supported systems.

SALES PROCEDURE

Eligibility is limited to full-time faculty, staff and students as determined by University of Michigan records. Each person may buy only one computer of any type and may not resell it within 2 years. System selection assistance is available at the Computing Resource Center (CRC). To place an order, first configure the system at CRC. Take the configuration form to Photo and Campus Services (542 LS&A Building); payment in full is required in the form of a cashiers check or credit card (no cash). Pickup is at Information Technology Service Center, 535 W. William or, at an authorized IBM Education Product Specialist.

DELIVERY TIME

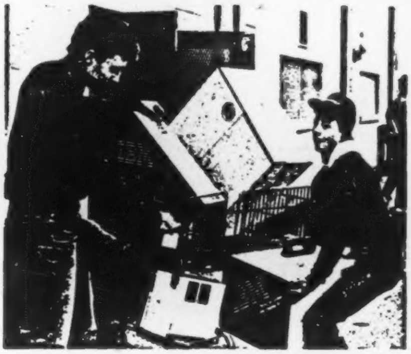
Approximately 4 to 6 weeks from order placement to pickup.

SERVICE AVAILABLE

During the 1-year warranty period, service is at either Information Technology Service Center (763-5897) or at any other authorized IBM service centers. Service after warranty is at the same locations.

Computer Weekend Surpasses Expectations

Computer Weekend was a "resounding success" according to Gregg Weiss, Computing Center MicroSales Manager. The sale, held October 9 and 10 at the University Coliseum, provided an opportunity for U-M students, faculty, and staff to purchase Apple, IBM, and Zenith microcomputer systems at reduced prices.



Students Dave Roden and Jim Olson unload boxes at Computer Kickoff —*Michigan Daily photo by Karen Handelman*

Computer Weekend may have been the largest microcomputer sale ever held. Over 3,000 computers were sold during the promotion, with more than 2,400 going to students, faculty, and staff and the remainder to departments. Despite the vast numbers, the sale went very smoothly. Most people made it through the pick-up process in under twenty minutes. This included a stop at the dealer area, where peripherals and supplies such as paper, disks, and modems were sold by ComputerLand of Ann Arbor, Inacomp of Ann Arbor, and the Learning Center, Ltd. While everyone was assigned a pickup time for their system, there was a major rush after 5:00 p.m. on Friday by those unable to make their appointed time. These purchasers may have spent up to seventy minutes in line.

Computer Weekend was designed and managed by staff from the Information Technology Division, Purchasing and Stores, Michigan Media, and other University departments. During the weekend itself, over 300 people helped out by loading grocery carts with systems, passing out surveys, and loading systems into cars. Of these 300 workers, over 80% were members of three student groups working to earn computer equipment: Galens, Nu Sigma Nu, and Women's Athletics. Marketing students from the School of Business Administration conducted a sale survey and are preparing reports from the collected data.

Because of the success of Computer Weekend and last winter's MacTruck Sale, the Information Technology Division may make Computer Weekend an annual event. Cooperation among local dealers, Apple, IBM, Zenith, and the University helped make the sale run well. Everyone

pitched in where needed—it wasn't uncommon to see IBM employees loading Apple carts, and vice-versa.

Approximately 1260 Macintosh, 575 IBM, and 525 Zenith systems with a retail value of over $10 million were delivered during the 18-hour sale. 1691 students and 669 faculty and staff bought new machines.

If you bought a microcomputer at the sale and have questions about your system, call the Computing Center Consultants at 764–HELP. You can also talk to a consultant at the Computing Resource Center (CRC), 3113 School of Education Building. The CRC is open between 8:00 a.m. and 5:00 p.m. Monday through Friday. If your your micro needs repair, contact Michigan Media Micro, 400 Fourth Street, at 763–5897. Michigan Media Micro is open from 8:00 a.m. to noon and 1:00 p.m. to 5:00 p.m. weekdays.

McMUG Meeting

Hospital Information Services is sponsoring a McMUG (Medical Campus Microcomputer User Group) meeting on Tuesday, November 10, from 3:00 p.m. to 4:00 p.m. in the Ford Amphitheater of University Hospital (UH–2A201). Roy Leban of Ann Arbor Softworks, Inc. will demonstrate Fullwrite Professional, a third-generation word processor. Designed for the Macintosh computer, Fullwrite includes WYSIWYG multi-column display, a spelling checker, mail merging, outlining, style sheets, automatic repagination, a MacDraw-like drawing environment, posted notes, and highlighted revisions.

Everyone is invited to attend. If you have any questions, please call Gloria Thiele or Tammy Whittaker at 936–4900. Both are also available through $MESSAGE on UB-MTS.

COMPUTER KICKOFF 87'
INCOME STATEMENT

REVENUE:			
Apple Bundle Sales	$3,099,645.12		
Excel Sales	29,295.00		
Zenith Bundle Sales	1,129,839.36		
IBM Bundle Sales	1,024,283.52		
Late Fees	8,400.00		
Cancellation Fees	1,920.00		
Zenith Commissions	25,290.00		
IBM Delivery & Support Fees	58,128.00		
Less Sales Tax	(203,280.23)		

Total Revenue			$5,173,520.77
COST OF SALES:			
Apple	$2,795,382.00		
Zenith	954,236.00		
IBM (incl. DOS)	856,174.00		
Microsoft Excel	27,710.67		
Microsoft Word	120,296.75		
Citizen	153,224.00		
Dealer STO	49,387.50		

Total Cost of Sales			$4,956,410.92

GROSS MARGIN			$217,109.85
OPERATING EXPENSES			
Event Planning (salary)	$45,310.00		
Order Processing (Salary & wages)	43,351.86		
Labor (incremental)	9,616.58		
Material Handling & Reconciliation	11,348.00		
Security	1,807.48		
Postage	43,117.90		
Printing	22,450.79		
Coliseum Rental	7,223.90		
Food & Beverage	3,545.70		
Supplies	2,970.68		
Equipment	2,889.65		
Identification	1,945.80		
Sign Ads	1,889.32		
Equipment Rental	1,877.50		
DSC Charges	1,850.00		
Phones Install & Charges	1,205.88		
Coliseum Renovation	1,052.11		
Insurance	923.08		
Advertising	789.00		
Dumpster Rental	766.00		
Union Rental	75.00		

Total Operating Expenses			$206,006.23

Net Gain/(Loss) without contingency			$11,103.62
Contingency: Non collectable checks		$1,514.16	

Net Gain/(Loss) with contingecy			$9,589.46
			================

APPENDIX D

Computer Kickoff '88 Price List

Config. #	Model	List Price*	Savings	Kickoff '88 Price with Sales Tax
A-1	Apple Mac Plus	$2,900.00	53%	$1,363.00
A-2	Apple Mac Plus with 20M Hard Drive	$3,544.00	53%	$1,655.00
I-1	IBM Model 30 Mono Monitor 20M Hard Drive	$3,441.00	48%	$1,773.00
I-2	IBM Model 30 Color Monitor with 20M Hard Drive	$3,894.00	48%	$2,025.00
Z-1	Zenith SupersPort Laptop	$3,179.00	50%	$1,587.00
Z-2	Zenith SupersPort Laptop with 20M Hard Drive	$4,427.00	52%	$2,107.00
A-3	Apple Mac SE	$3,628.00	50%	$1,813.00
A-4	Apple Mac SE with 20 M Hard Drive	$4,460.00	49%	$2,281.00
I-3	IBM Model 50 Z Color Monitor with 30M Hard Drive	$6,177.00	50%	$3,065.00
Z-3	Zenith Z-286 LP Color Monitor with 20M Hard Drive	$5,664.00	57%	$2,417.00
A-5	Apple Mac II Color Monitor with 140M Hard Drive	$8,975.00	51%	$4,421.00
I-4	IBM Model 70 Color Monitor with 60M Hard Drive	$8,979.00	50%	$4,516.00
Z-4	Zenith Z-386 Color Monitor with 40M Hard Drive	$8,987.00	58%	$3,815.00

Optional Printers

Config. #	Model	List Price*	Savings	Kickoff '88 Price with Sales Tax
P-1	Apple ImageWriter II	$650.00	43%	$374.00
P-2	Apple LaserWriter II SC	$2,994.00	41%	$1,763.00
P-3	Citizen MSP-40	$540.00	49%	$276.00
P-4	HP LaserJet II	$2,824.00	44%	$1,583.00

Note: If any further price reductions are obtained on this equipment, the new and lower price will be passed on to buyers at the time of final payment, or in the case of paid-in-full, a refund will be issued.

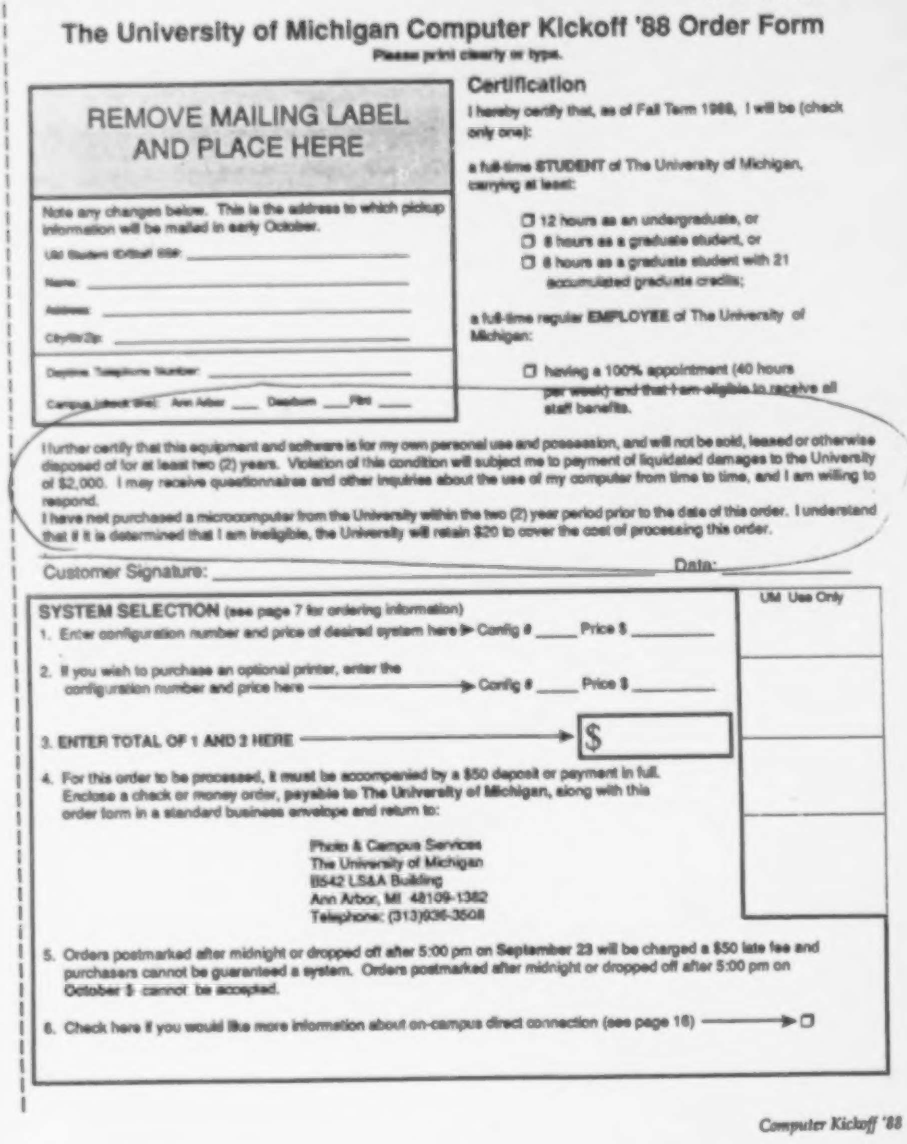
*** Manufacturers List Price as of 6/24/88 including software and 4% Michigan sales tax**

COMPUTER PRICES 9/88

Configuration	U/M Computer Kickoff Sell Price	U/M Regular Sell Price	TPI COST	TCBC CORP. COST	TPI CLONE Sell Price
1) IBM Model 70 Color monitor Mouse, Dos 4.0 Microsoft Word	$4342.30	$4262.00	$4873.00	$4381.00	$4730.00
2) IBM Model 50Z Color monitor Mouse, Dos 4.0 Microsoft Word	$2947.12	$3062.00	$3353.00	$3021.00	$3095.00
3) IBM Model 30 Color Monitor Mouse, Dos 4.0 Microsoft Word	$1947.12	$2096.00	$2326.00	$2101.00	$2049.00
4) Same as #3 but Monochrome monitor	$1704.81	$1811.00	$2007.00	$1816.00	$1749.00

NOTES :
- All prices are exclusive of sales tax.
- The TPI clone prices do not include the possibility of the buyer purchasing Microsoft Word from direct from the U/M an hence would further reduce the listed prices by about $200.00. The clone prices also do not reflect any price reductions due to massive sale quantities.
- TCBC Corp. costs are those which our franchise HQ, who purchases at the best IBM discount, incurs for the equipment. These are the "C" level prices.
- TPI costs are those that I, as Technology Partners, pay. These are nominally the "B" level prices.

APPENDIX E



The University of Michigan Computer Kickoff '88 Order Form

Please print clearly or type.

REMOVE MAILING LABEL
AND PLACE HERE

Note any changes below. This is the address to which pickup information will be mailed in early October.

UM Student ID/Staff SS#: ______________

Name: ______________

Address: ______________

City/St/Zip: ______________

Daytime Telephone Number: ______________

Campus (check one): Ann Arbor ___ Dearborn ___ Flint ___

Certification

I hereby certify that, as of Fall Term 1988, I will be (check only one):

a full-time **STUDENT** of The University of Michigan, carrying at least:

- ☐ 12 hours as an undergraduate, or
- ☐ 8 hours as a graduate student, or
- ☐ 6 hours as a graduate student with 21 accumulated graduate credits;

a full-time regular **EMPLOYEE** of The University of Michigan:

- ☐ having a 100% appointment (40 hours per week) and that I am eligible to receive all staff benefits.

I further certify that this equipment and software is for my own personal use and possession, and will not be sold, leased or otherwise disposed of for at least two (2) years. Violation of this condition will subject me to payment of liquidated damages to the University of $2,000. I may receive questionnaires and other inquiries about the use of my computer from time to time, and I am willing to respond.
I have not purchased a microcomputer from the University within the two (2) year period prior to the date of this order. I understand that if it is determined that I am ineligible, the University will retain $20 to cover the cost of processing this order.

Customer Signature: ______________ Date: ______________

SYSTEM SELECTION (see page 7 for ordering information)

UM Use Only

1. Enter configuration number and price of desired system here ➤ Config # _____ Price $ _________
2. If you wish to purchase an optional printer, enter the configuration number and price here ——➤ Config # _____ Price $ _________
3. **ENTER TOTAL OF 1 AND 2 HERE** ——➤ $
4. For this order to be processed, it must be accompanied by a $50 deposit or payment in full. Enclose a check or money order, **payable to The University of Michigan**, along with this order form in a standard business envelope and return to:

   Photo & Campus Services
   The University of Michigan
   B542 LS&A Building
   Ann Arbor, MI 48109-1382
   Telephone: (313)936-3508

5. Orders postmarked after midnight or dropped off after 5:00 pm on **September 23** will be charged a $50 late fee and purchasers cannot be guaranteed a system. Orders postmarked after midnight or dropped off after 5:00 pm on **October 5** cannot be accepted.
6. Check here if you would like more information about on-campus direct connection (see page 16) ——➤ ☐

Computer Kickoff '88

The Microcomputer Sales Program

Advanced information technology has become increasingly important at The University of Michigan. Every discipline uses powerful, low-cost personal computers that support sophisticated data analysis, word processing, and graphics. The Microcomputer Sales Program is designed to enhance the quality of education as a component of the educational mission at The University of Michigan by providing individuals access to information technology at a reduced cost. The program is administered by the Information Technology Division and managed by the Computing Center in cooperation with University Stores. The Microcomputer Sales Program gives individuals the opportunity to make a personal investment in technology by offering a variety of equipment that is deemed appropriate for use in this environment.

The program operates on a cost recovery basis; it receives no subsidy and generates no profit. The prices of the equipment include a small markup for the Sales Program's handling charges and overhead. Local computer dealers participating in the program receive a fee for their support, which is also included in the final cost.

All full-time students of The University of Michigan are eligible to purchase one system every two years. All full-time faculty and staff are also eligible to purchase equipment to enhance the educational mission and employment productivity of The University of Michigan by promoting the computer literacy of the faculty and staff. This opportunity is not intended to be a "perk" of employment. The University Microcomputer Sales Program is not intended as a general purpose distribution channel for microcomputers. The privilege to participate in the program is limited to the student, faculty or staff member alone and is not extended to others, including: purchase for a family member, purchase for a friend or purchase for resale.

All purchasers are required to sign a contract with the University in order to participate in the program. The contract states, "I further certify that this equipment and software is for my own personal use and possession, and will not be sold, leased or otherwise disposed of for at least two (2) years." If you do not plan to be the primary user of the equipment, then you should not purchase equipment through this program. Further, the agreement states that violation of such will subject you to payment of liquidated damages of $2,000 to the University. If you refuse to answer questions, whether by mail, phone or in person, as to the whereabouts and use of the equipment, or you are found to not be in possession of the equipment, you will be considered in violation of the agreement and will be charged the agreed upon $2,000.

ITD established this program to provide the opportunity for all interested and eligible faculty, staff and students to purchase supported microcomputers and software at substantially reduced prices. Thank you for your help in ensuring that the program is used to support the educational mission of the University.

APPENDIX F

The Following excerpt was published by the Ann Arbor Chamber of Commerce in their booklet promoting their "Small Business Week" event of May 1988. As the excerpt explains the speaker, Peter Pellerito, is the Director of Community Relations for the U/M as well as the Chairman of the Board for the Ann Arbor Chamber of Commerce. He has recently assumed the role of acting President of the Chamber.

After reading the article I contacted the Business School as well as the Chamber Innovation Center and neither were aware of any such program. The Business School did inform me that I could acquire consulting services from their faculty for a $500.00 to $5000.00 per day fee.

The Innovation Center suggested I contact Mr. Pellerito directly which I did and was greeted with a very surly conversation. (I wrote him to complain and offered to meet him to discuss our differences but he never responded). His comments boiled down to that 1) he didn't remember making the comments and 2) The U/M did offer access to the SCRIPT database which only allowed small business people to find out the topics of research that those on campus were involved in.

Big Deal.

Throughout the week, mining the area's rich variety of resources will be emphasized. Peter Pellerito, Director of Community Relations for the University of Michigan and Chairman of the Board of the Ann Arbor Area Chamber of Commerce, reflected the goals of Small Business Week in a recent statement about resources offered by the University. He said, "Although the University of Michigan is well known as a large research university, we do not forget the role of small business in our local and state economies. The University offers several services to small businesses, including SCRIPT (an information retrieval service), business school faculty consultation with small business, and professional services of faculty through the Chamber Innovation Center. The important thing for small businesses to know is that the University is available, can be of service, and is prepared to develop partnerships with small businesses to achieve our collective goals."

TCM The Travel Mart, Ltd.
Wilmette's First and Most Modern Computerized Travel Service

October 3, 1988

OCT 06 1988

Congressman John La Face
Chairman of the Committee on Small Business
Rayburn House Office Building, Room 2361
Washington D.C. 20515

Attention: Roy Dye

Re: Field Hearings
Chicago, Illinois 10/1/88

Dear Congressman La Face:

As time did not permit testimony at your hearings in Chicago, I would appreciate it if you would include this item in your field hearing report.

Enclosed is a brochure that is mailed to all residents in the New Trier School District under a Non-Profit Bulk Mail Permit. The New Trier Extension offers a wide range of travel products that have no bearing on education but do entice many of our residents who formerly dealt with local agents.

As a real estate taxpayer in this district, I feel that as the largest portion of my tax dollar is spent on supporting the schools, this activity of conducting a travel agency business is totally unacceptable.

I am also enclosing a copy of a letter sent to Senator Paul Simon that clearly states recommendations of the Postal Commission to Congress.

Thank you so much for your kind consideration in this matter.

Very truly yours,

Lorrie Knorr

MEMBER ASTA American Society of Travel Agents

1150 Wilmette Avenue, Wilmette, Illinois 60091 • Phones: (312) 256-1010 • Chicago (312) 273-2270
Cable: Travelmart, Wilmette • TELEX 495 0763

588 JUL 2

UNITED STATES POSTAL SERVICE
Government Relations Department
475 L'Enfant Plaza, SW
Washington, DC 20260-3500

July 19, 1988

Honorable Paul Simon
United States Senate
Washington, D.C. 20510-1302

Dear Senator Simon:

This is in response to your July 7 letter on behalf of Ms. Dorothy Werner of Springfield, concerning mailings by nonprofit organizations.

Third-class mailers who are eligible for reduced rates enjoy that privilege at the discretion of Congress. Congress defines the criteria that determine eligibility for preferred rates, and also furnishes appropriations to offset the revenue forgone by the Postal Service in providing mail services at reduced rates.

Once an organization has established, by the presentation of evidence, that it is entitled to authorization to mail at the special rates, the Postal Service has no discretion to refuse to accept properly prepared mail of the nonprofit organization.

The Postal Service has no legal authority to interfere with a mailing by a nonprofit organization because it may be in competition with a profit making organization.

Others have expressed the same concern as you have. Consequently, the Postal Rate Commission, after long study, has made several recommendations to Congress. One is that any mailing which "advertises or promotes the sale of, recommends the purchase of, or announces the availability of any article, product, service, insurance, or travel arrangements," could not be transmitted through the mails at preferred rates. This would be an entirely new concept, relating the use of special rates to the content of the mailing rather that to the nonprofit status of the organization. The Rate Commission's findings were reported to Congress on June 18, 1986.

If I may be of further assistance, please let me know.

Sincerely,

James V. Hitaffer

James V. Hitaffer
Representative
Office of Government Liaison

NEW TRIER
eXtension
continuing education at New Trier High School since 1939

August 1988

Friends:

About our gold banner ...
When it began in the fall of 1939, it was called the "Adult Evening School." The 19 courses in that first catalog *were* all held in the evening and attracted 253 students. As we begin our 50th year, we serve well over 7,000 students annually. This fall alone, we're offering more than 250 daytime and evening classes, including some on Saturdays. Just ten years ago, we added the travel dimension to our program. On our first trip, 18 people ventured off to Italy (and we at home hoped we'd remembered all the necessary details!). We now offer an average of 24 trips a year and have a file of nearly 3000 travelers from 47 states. There's no question about the growth and service of New Trier eXtension. And there's no question about the community that New Trier eXtension serves — wonderful people who never lose their enthusiasm for learning.

We invite you to be part of this proud, 50-year tradition by taking or teaching a course this year — or by traveling with us — as we begin the second half of our first century. If we've done our work, you'll find plenty to tempt you in this golden catalog:

- nearly 40 new courses spanning a broad range of interests
- details of eight new trips — with more to come in 1989
- the re-opening of the pool for an extensive program of children's swimming activities
- the introduction of "Language Nights" as a community service offered by our language faculty

If you haven't been with us before, perhaps you are not aware of these points:

- that New Trier eXtension is totally self-supporting
- that tuitions are always the same for in-district and out-of-district residents
- that our trip leaders are always trusted faculty members from New Trier High School or from NTX
- that 3800 out-of-district residents have asked to receive our catalog regularly

We like to think that there are many reasons in *addition* to our 50th anniversary to put a gold banner on our cover. We hope you'll agree. And we hope you'll join us this year — in particular — to mark the "Center of a Century" for NTX. It promises to be a banner year.

Best wishes,

William J. Boyd, *Director*

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NTX classes follow the calendar on page 38.

NEW TRIER TOWNSHIP HIGH SCHOOL · DISTRICT 203 ·

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Jane Lowndes, *Evening Supervisor, NTC*
Nancy Scheller, *Assistant Director*
Marian Ware, *Data Processor*
Jean Wilson, *Travel Coordinator*

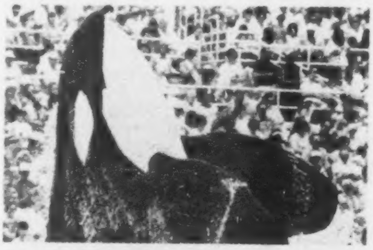
Discover America's Cities!

Designed to let you explore special cities on long weekends, this new series features knowledgeable and enthusiastic leadership, compatible groups, airfare and transfers, centrally located hotels, orientation tours, and specific suggestions to help you tailor the weekend to your own interests. Our goal is to choose cities of unusual quality that will appeal to our intelligent travelers. Many more destinations are planned for you in the future. We hope you will come with us — to discover America's cities!

Fabulous Philadelphia $434

Columbus Day Weekend (Oct. 8-10)
with Jim Marran

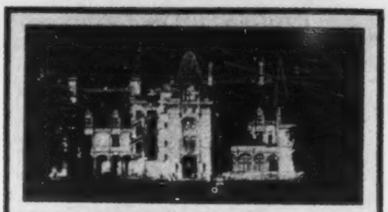
Let the "City of Brotherly Love" make your weekend a memorable one. Highlights will include a general city tour, a walking tour of the historic district, and a chance to stroll through the University of Pennsylvania campus, visit the Philadelphia Museum of Art, and sample the city's great variety of restaurants. Jim is a native of the area, and is eager to share it with you. Travel for this group is now scheduled on United from O'Hare. Please call to request a brochure. There is an early September registration deadline.
Preview: Thursday, September 1 at 7:30 PM at New Trier Central



San Diego Safari $539

Casimir Pulaski Day Weekend (Mar. 3-6)
with Sandy Swan

Ever wanted to explore the world-class San Diego Zoo? Ever dreamt about the blue Pacific while dragging through Illinois' winter dregs? This trip includes three nights on Mission Bay at the Bahia Resort Hotel, air travel via United, and an extensive tour of the area. Our hotel location will permit easy access to the entire city on economical public transportation. Sandy will plan visits to Sea World and the San Diego Zoo in Balboa Park — and to other places of interest that can be added on an *optional* basis. Please call to request a brochure.



Asheville: A Scenic Retreat $434

Veterans' Day Weekend (Nov. 11-13)
with Sandy Swan

Welcome to the Blue Ridge country of western North Carolina. We'll visit the magnificent Biltmore Estate, watch native artisans as they create the arts and crafts for which the area is so well known, and relax as we look out over the expansive views along the Blue Ridge Parkway. It's not surprising that the city has become such a popular retirement setting. Please call to request a brochure. Registration closes early in October. Limited space remains at this time.
Preview: Thursday, September 8 at 7:30 PM at New Trier Central

North to Toronto $375

Martin Luther King Day Weekend (Jan. 13-16)
with Carey Mestjian

Discover one of the most cosmopolitan cities north of the border. We know very well what the weather will be like in Canada this weekend — and we also know how well suited this city is to the activities we've planned. With outstanding museums and *miles* of covered shopping areas (city-center shops are linked by subterranean walkways), our travelers will enjoy exploring Canadian history, art, and culture. This trip includes air on United, three nights at the centrally located Delta Chelsea Hotel, a city tour, and a special lecture in Toronto on Canada's current economic and political scene. With Carey's spirited leadership and the opportunity to add *optional* performances, here's a wonderful winter weekend bargain! Please call to request a brochure.

more TRAVEL

Weekend Bicycling in Door County $139

Sept. 30-Oct. 2 with Tom McCabe

Room is still available for this popular trip! Enjoy the fall color show as you ride along quiet country roads — all at your own pace. Registration must be completed by early September, so please call immediately to request a brochure.

A Holiday Weekend in Iceland $589

Oct. 5-9 with Penny Trieschmann

This trip is full and limited space remains on the *1989* trip. We will be happy to add your name to the list for 1989. An extra day has now been added to the trip, so even more time can be enjoyed in this fascinating country.

The Stratford Theatre Festival 1988 $299

Oct. 13-16 with Allen Schwartz

If you love theatre (and beautiful fall color!), you are sure to enjoy the Stratford Theatre Festival. Join NTX for our ninth consecutive year at the Festival. This fall's plays are *The Two Gentlemen of Verona*, *My Fair Lady*, *King Richard III*, and *All's Well That Ends Well*. Allen's knowledge and experience are guaranteed to deepen your appreciation of theatre. The cost includes transportation, housing, two lunches, and excellent seats at all four shows as well as preview and review sessions at New Trier Central. A descriptive brochure will be mailed upon request. Registration closes in mid-September.

The Treasures of Tuscany $1819

Oct. 14-23 with Antonella Mobarhan

The itinerary includes Florence and Siena (and you may extend the trip). Only four spaces remain at press time, but we welcome your inquiry.

Spain and Portugal $2599

Oct. 15-29 with Bonnie Lytle

Last call for an exciting itinerary! Please inquire now, and we'll try to accommodate you. You may extend this trip.

Gemütlichkeit in Munich $999

Nov. 12-20 with Antje Draganski

Our 1988 "thank you" trip takes you to the capital of Bavaria for a week of pleasant activities and relaxation. Antje, a native of Germany, is eager to share the city's culture with you — everything from Nymphenburg Castle to Olympic Park (site of the 1972 Olympics) to Marienplatz, with brass bands to boot! An excellent city-center hotel, orientation tour, a few meals, and planned daily activities make this a fine travel opportunity. When you include air travel via Lufthansa and Antje's enthusiastic leadership, the travel value increases even more! You may extend this trip. Please call to request a descriptive brochure. A registration decision is due in September.

Preview: Thursday, September 1 at 7:30 PM at New Trier Central

London Theatre $1099

Dec. 25 (evening)-Jan. 2 with Bill Boyd

Join NTX for our sixth holiday excursion to the capital city of theatre! You'll enjoy time to explore this exciting destination at leisure — the museums, the byways, the people — and the *great* sales traditional at this time of year. Best of all, there is an abundance of theatre and music to be savored with your fellow theatre-lovers. What a great way to ring in the new year! Our low cost includes experienced leadership, travel on TWA, a superior first-class hotel, breakfast each morning, a "high tea," three theatre tickets and the New Year's Eve concert by the London Symphony, and a week's pass on London Transport, the key that opens the entire city to you. You may extend this trip. Only a few spaces remain at press time.

Preview: Thursday, September 8 at 7:30 PM at New Trier Central

Yucatán: Land of the Ancient Maya $2099

Jan. 27-Feb. 9 with Jean Wilson

Designed for the person seeking both a warm-weather destination *and* a fascinating look at the remains of a great civilization, this trip is sure to please. Uxmal, Chichen Itza, Palenque — these are just a few of the main stops as you investigate art, architecture, and history under the Caribbean sun. Luxurious housing, most meals, and expert local guides are among the many features NTX offers. Flights are on United and Mexicana Airlines. Please call for a trip brochure.

We think we give you more for your travel dollar — more attention to detail, more qualified leaders, more of the kind of travel experience you really want . . .

Coming in 1989 ...

Information about these new trips will appear in our Spring Term catalog. Individual trip brochures will be ready later, but you may call now to request those that interest you. Fully refundable $25 per person deposits are being accepted now.

- ***Capitalize on Washington*** *(May 27-29) with Kathleen Picken*
- ***York and the Lake Country*** *(Summer) with Kathleen Picken*
- ***Walking in Europe (Zermatt)*** *(Sept. 30-Oct. 10) with Bill Boyd*
- ***Calgary Calls*** *(Oct. 7-9) with Nancy Scheller*
- ***San Antonio: Sunshine and Sombreros*** *(Nov. 10-12) with Fred Egloff*
- ***Hong Kong: Oriental Gateway*** *(Dec. 26-Jan. 2) with Carey Mestjian*
- ***A Russian New Year*** *(Dec. 26-Jan. 4) with Shirley Carlson and Jean KixMiller*

more TRAVEL

Spring Vacation

a wonderful time for a change of scene

We have purposely planned the following three trips for the week of March 31-April 9 so that families and adults who are free that week may enjoy economical and meaningful travel. We've chosen destinations with fascinating cultures and history. We've found superb trip leaders. Just about the only thing we *haven't* done is decide which trip you should choose. We thought you'd enjoy doing that.

Athens: Classical Paradise **$1259**

Mar. 31-Apr. 8 with Linda Ambrozik

This trip offers the variety of Athens itself — everything from ancient Greek temples to traditional dishes served at a family *taverna* — and much more. Excursions include full-day tours to Delphi and to Corinth, Mycenae, and Epidaurus, and a full-day cruise to Hydra, Poros, and Aegina. Our group will fly on SAS and stay in the first-class Astor Hotel. On the way home, we'll spend a night in Copenhagen. You may extend the trip in either Athens or Copenhagen. Please call for a descriptive brochure.

London Theatre II **$1189**

Mar. 31-Apr. 8 with Carey Mestjian

Our London Theatre trips have proved so popular that we've planned a springtime "repeat" trip to accommodate our travelers. Our package includes round-trip air via TWA, seven nights in the tourist-class President Hotel in atmospheric Bloomsbury Square, continental breakfast daily, transfers by private coach, and tickets to four shows during the week. In addition, group members will have a seven-day London Transport Pass — a feature that puts the entire city within easy reach. Carey will plan daily excursions around the city as well. An *optional*, low-cost day trip to Oxford for a visit to one of the world's great universities is also available. You may extend this trip. Enjoy London — and its great theatre! Please call for a trip brochure.

"¡Viva, Madrid!" **$1249**

Mar. 31-Apr. 9 with Raymond Ledinsky

Absorb the rich culture of Spain during a full week in this exciting capital where you can stroll the great boulevards and relax in the peaceful parks. Activities will be planned for each day, but you'll be free to explore on your own if you wish. Together we will enjoy a city orientation tour, a welcoming dinner, and a farewell dinner (at El Botin's). Ray is eager to share two full-day excursions into the country with you — one to Toledo and the other to Escorial and the Valley of the Fallen. Our week concludes with a night in Copenhagen. You may extend the trip in either Madrid or Copenhagen. Please call to request a brochure.

Burgundy: Art and Vineyards **$1599**

May 12-23 with Janine Pefley

France in the springtime. The charm of Burgundy and an extended stay in Paris. The inspiring leadership of Janine Pefley. This third trip in our French series is certain to be a sell-out. The itinerary offers three days in Dijon, three in Bourg-en-Bresse, and four in Paris. Quaint villages, wine tastings, charming, hand-picked hotels, and spectacular art museums round out this exceptional travel experience. Air travel is via Air France, and ground transfers are by private coach. You may extend this trip. Please call to request a brochure.

The Trains of Europe: The Many Lands of Switzerland **$1589**

May 19-29 with Bill Boyd

The eighth in one of our most popular series, this trip explores Switzerland in depth. Using Chur, Zermatt, and Bern as "hub" cities, we'll use the wonderful train, boat, and post bus system to take in the country at a leisurely pace. The trip includes flights on American Airlines, excellent hotels, several superb meals, and first-class rail travel throughout. A special feature this year will be a five-day extension ($349) that adds one more day to the Bern stay and ends with four days in Locarno in a lakeside hotel. You may choose other extensions as well. Ride the trains and enjoy the many lands of Switzerland! Please call for a descriptive flyers.

UNDERWRITERS LABORATORIES INC.®
333 PFINGSTEN ROAD · NORTHBROOK, ILLINOIS 60062—2096
an independent, not-for-profit organization testing for public safety

TESTIMONY TO SMALL BUSINESS COMMITTEE

U.S. HOUSE OF REPRESENTATIVES

(October 1, 1988)

I am Jack Bono, President of Underwriters Laboratories Inc. (UL). With me is Joe Bhatia, who is in charge of our Washington, DC, office.

I thank this Committee for the opportunity to express UL's views concerning our tax exempt status. As you know, this has been the subject of complaint by certain commercial laboratories who recommend that the exemption be eliminated. Let me state, at this point, that these commercial laboratories do not reflect the position of the small business community as a whole. UL is a friend of thousands of small businesses who benefit greatly from our services and who support UL and its comprehensive role in product safety. These businesses would not want to see a restriction in UL's role. I will comment further on this point later in my testimony.

We have entered into the record, for your consideration, a statement which describes the origins of UL; the public services it performs; and the reasons that the

Look For The UL Listing or Classification Mark On The Product
Phone: (312) 272-8800 MCI Mail No.: 254-3343 Cable: ULINC NORTHBROOK, IL MCI Telex No.: 6502543343 FAX No.: (312) 272-8129

recommendation to eliminate the exemption in the IRS Code for nonprofit organizations "testing for public safety" is unwise as a matter of tax policy and is based on false premises. Furthermore, our statement contends that, if UL's tax exemption is eliminated, this will cause an increased cost to be incurred by both the government and the general public; it will result in an overall reduction of the safety levels enjoyed in the U.S. today; and it will diminish representation of U.S. interests in international trade and standards development activity.

A brief history of UL's tax exempt status may be in order. UL has always been a not-for-profit corporation. From UL's inception in 1894, any excess income has been plowed back into the safety mission. Until 1935, UL was exempt from taxes under the category of scientific and educational institutions. In 1935, even though UL's total involvement was still in public safety, the IRS ruled that we did not fit the category, since it was intended for universities and other such institutions, and we were required to pay federal income tax. In 1954, Congress, in recognition of the unique role and importance of UL, revised the Code to exempt nonprofit organizations "testing for public safety," which was at that time and still remains UL's motto.

In the interest of time, I will confine my testimony today to a listing of what I believe are the more important points to consider in conjunction with UL's operation and responsibilities, its tax exempt status, and its relationship with small business.

October 1, 1988

When UL was formed 94 years ago here in Chicago, it had one purpose - by scientific investigation to reduce injury, loss of life, and property damage. That purpose has never been changed or diluted.

The way we did it in the early years was fairly straightforward. We conducted safety engineering evaluations on products. If they met safety requirements, we inspected production periodically for continued compliance and the products were authorized to carry the distinctive UL Mark.

As the safety system began to evolve in the U.S., UL's role could no longer be confined to these basic functions. UL had to assume responsibilities required by the safety system - responsibilities shouldered by no other laboratory. Let me list some:

- Develop product safety standards - 541 of them to date.
- Participate in development of Building Codes, the National Electrical Code, and other installation standards. Without this involvement, we could not develop product standards that are compatible with these Codes. UL staff serve on over 500 safety related committees of other organizations.
- Represent U.S. views in international standards committees. About 40 UL staff participate in 140 committees, subcommittees, and other international groups.

October 1, 1988

- Undertake harmonization of U.S. and international or foreign national standards. The commentary which accompanied the draft of the U.S.-Canada free trade agreement, for example, specifically references and encourages the harmonization effort between UL and the Canadian counterpart, the Canadian Standards Association.
- Assist Federal agencies, state and municipal authorities with their regulatory and/or procurement responsibilities by providing information, training, and other services.
- Provide educational materials and information to schools and consumers.
- Conduct essential safety research.
- Assist U.S. manufacturers in complying with safety requirements and gaining acceptance of their products in other countries.

UL's cost last year for these essentially nonrevenue producing activities was approximately $10 million, but this is a necessary expenditure for UL to do what is expected of us. Since these activities are simply expense items, commercial laboratories participation in such activities is virtually nil. This is just one of the differences between UL and profit-making laboratories.

Let me make a few additional points:

October 1, 1988

(1) The legitimate concern expressed by small business is that nonprofit organizations are encroaching on business activities commonly carried out by commercial companies. In almost every instance, the opposite is true with respect to the historical and traditional product safety certification work of UL.

A handful of profit-making laboratories are now choosing to enter the traditional UL product safety area. They pick and choose certain income-producing areas of UL work, using UL standards and procedures, while leaving to UL the non-income activities.

Of the 12,500 product categories in which UL is involved, there are only two areas which have been cited as encroachment by UL. One concerns the evaluation of toxicity of combustion products from burning materials and the other concerns the measurement of electromagnetic interference (EMI) from electronic devices.

Both of these are emerging technologies impacting on safety. Most fatalities in a building fire are the result of toxic products, not burns. With the advent of more and more synthetic materials (plastics) in buildings, the measurement of the toxic potential from the combustion of such materials is increasingly important. At the moment, the scientific community, including UL, is developing test methodology and test data, even though the application of results for hazard assessment is not formally agreed upon. Clearly, UL, which has for many years determined and certified other hazard characteristics of materials, such as flame spread and heat contribution, should be involved in this safety problem. When a consensus is reached in how to apply the data UL will add toxicity ratings in its safety certification of materials. This is consistent with UL's policy of examining products for all reasonably foreseeable hazards.

Similarly, our lives are becoming populated with electronic devices. Electronic controls, microwave ovens, computers, garage door openers - all kinds of products are controlled, started, shut down, or caused to function by electronic signals. EMI can impact on these functions. EMI can interfere with transmissions to airplanes, paramedics, police, and other services. It can interfere with proper operation of burglary protection systems. UL, in carrying out its safety responsibilities, cannot ignore these potential hazards brought on by emerging technologies.

Our interest in EMI is confined to safety. Unlike commercial EMI laboratories, UL does not conduct experimental testing for manufacturers and assist them in the design of products to meet EMI requirements. Our objective is very specific and that is to determine that products meet safety requirements of the Federal Communications Commission (FCC). In fact, it was the FCC that urged UL to become involved in this area. In some instances, U.S. manufacturers need to have their products meet EMI requirements of safety organizations in other countries. UL can provide data for this purpose; just another way in which UL assists U.S. industry in promoting exports.

(2) In most countries, many of the functions carried out by UL are assumed or financially supported by the national government. If UL was forced to cut back on these functions because of a tax burden, either our Federal Government would need to assume them or public safety would be compromised.

(3) From the viewpoint of the interests of this Committee, I want to emphasize the value of UL to small businesses. The presence of the UL Mark on products manufactured by small businesses provides an access and acceptance in the marketplace which would otherwise be difficult to achieve, particularly if similar products are available from large corporations with instant name recognition. The UL capability for safety evaluation and recognition of new and innovative products permits the inventive and entrepreneurial nature of small business to realize a needed return by providing confidence in and acceptance of such products by retailers, inspection authorities, and consumers. The large majority of UL clients are small businesses.

(4) When UL's tax exemption became a subject of recent study by another Congressional Committee, the unique role of UL in the U.S. safety system and UL's relationship to the various

interests which make up the system were clearly demonstrated by letters sent to Congress supporting UL's role and urging that it not be diminished. Those letters came from Federal, state, and local government officials, small and large businesses, trade associations, contractors and union organizations, retailers, consumers, and others. These letters, from a wide spectrum of interests, I believe, demonstrated to the Committee, the IRS, the Treasury, and the Joint Committee on Taxation, who were all studying this issue, what we meant by the U.S. safety system and how UL was an integral part of the system.

Conclusion

UL's status as a tax exempt organization deserves to be continued because public safety needs to be supported. The support from the Federal Government, represented by the tax savings as a result of UL's exempt status, is a minimal cost for the comprehensive services provided by the Laboratories to so many groups. The rapid technological developments today bring special safety problems which UL needs to address with modern facilities and equipment.

It would indeed be ironic if the efforts of a small segment of the small business community brought about a result which would detrimentally impact on thousands of other small businesses who rely upon and benefit from the services of Underwriters Laboratories.

UNDERWRITERS LABORATORIES INC.®
333 PFINGSTEN ROAD · NORTHBROOK, ILLINOIS 60062—2096
an independent, not-for-profit organization testing for public safety

STATEMENT OF UNDERWRITERS LABORATORIES INC. CONCERNING ITS TAX STATUS TO THE HOUSE COMMITTEE ON SMALL BUSINESS

Background

In late June the House Committee on Small Business conducted two days of hearings on the issue of competition between non-profit and for-profit organizations. Two representatives of profit-making laboratories registered their complaints against the "testing for public safety" exemption in the IRS Code.

Since 1954, the Code has included an exemption from tax for organizations that engage in "testing for public safety," if the organization satisfies the other requirements of Section 501(c)(3) of the Code. This provision was included in the Code expressly for Underwriters Laboratories (UL). Congress had properly concluded that testing for public safety served a vital public purpose, and that UL should be encouraged and supported in its efforts. It should be noted that the Code does not confer a charitable deduction for contributions to such testing organizations. The sole tax benefit is that the organization is not itself subject to tax.

Look For The UL Listing or Classification Mark On The Product

Phone: (312) 272-8800 MCI Mail No.: 254-3343 Cable: ULINC NORTHBROOK, IL MCI Telex No.: 6502543343 FAX No.: (312) 272-8129

From the perspective of the House Committee on Small Business, it is important to make the point right up front that UL provides a valuable service to small and large businesses, that small businesses using such services gain a recognition and acceptance of their products in the marketplace which they would otherwise find difficult to obtain and that the few profit-making laboratories who have registered their views about "unfair competition" do not speak for the business community who utilize UL's services. This subject will be further addressed in this statement.

The elimination of UL's tax-exempt status would be a grievous error. The remainder of this statement will explain why.

UL was Founded in 1894 for the Express Purpose of Reducing Bodily Injury, Loss of Life, and Property Damage -- UL has Never Departed From This Mission

UL was established to fill a need which had been manifested by the first large-scale use of electricity which took place at the Columbian Exposition held in Chicago in 1893.

UL has provided services of inestimable value to society in the field of public safety -- services which, if not performed by UL, would either have had to have been performed by Federal, state, or local governments or, if not performed at all, would have resulted in significantly increased risks to life and property of American consumers.

It can be factually stated that, in the course of a single day, every individual reading this statement is relying on literally hundreds of products which have been evaluated by UL and for which major safety contributions have been made, including heating and cooling equipment, electrical distribution and building construction materials, cooking, audio, visual and entertainment appliances, and a vast array of products in everyday use.

In 1987, as in all the previous years, all of UL's activities and revenue generation involved testing, standards writing, inspection and other related activities devoted to the express purpose of public safety.

UL, as a Membership Corporation Without Capital Stock, is Uniquely Structured to Respond to Public Safety Needs

Membership in UL is limited to safety and standardization experts, to representatives of consumer, education, and public safety interests, and to representatives of public utilities, the insurance industry and government. Manufacturers, vendors and any person or organization who submit products to UL for evaluation are prohibited from becoming a member of UL or its Board of Trustees.

This structure and the not-for-profit status of UL enhance its independence and lend credibility to its findings.

Today, UL is a worldwide organization with four major facilities at which safety standards are developed, and systems, equipment and products are evaluated. UL's four laboratories are located in Illinois (headquarters), California, New York and North Carolina. Its current staff of engineers, scientists, field service members and support personnel number 3,800.

Other laboratories' involvement in product safety is of recent vintage, or is highly specialized, and does not encompass the scope and responsibilities which UL has been required to assume in the U.S. safety system.

UL Differs in Fundamental Ways from Commercial Testing Laboratories and is an Integral Part of an Established United States Public Safety System

Unlike profit-making laboratories, UL conducts many non-revenue producing activities which are required to make the system work for protection of the public.

The principals in this system include:

(1) Developers of installation codes

(2) Federal, state and municipal authorities

(3) Manufacturers - both large and small businesses

(4) General public, governmental authorities and insurance groups

(5) UL -- the independent third party

No other organization, governmental or private, fulfills the comprehensive role carried out by UL as an integral part of the safety system.

UL Differs in Fundamental Ways from Commercial Testing Laboratories and Provides Unique Services in Carrying Out its Responsibilities as an Integral Part of the United States Safety System

These are:

(A) Development of product safety standards

(B) Participation in international standards development

(C) Harmonization of U.S. standards with international and foreign standards

(D) Involvement in a major way in code-making activities

(E) Conduct of essential and timely research related to safety

(F) Provision of safety educational materials and information

(G) Provision of support to Federal, state and municipal authorities

(H) Formation and utilization of forums for involved individuals

(I) Assisting in assuring that unsafe products are not dumped on the U.S. market from foreign sources

Profit-making commercial laboratories do not provide this complete program. They, using UL developed standards and procedures, pick and choose only certain income producing activities of this traditional UL work, leaving to UL all of the non-revenue activities and responsibilities required by our role in the U.S. safety system.

UL Makes a Major Contribution to Small Business

UL serves literally thousands of small businesses who support UL's position that its ability to carry out its safety role not be diminished by a requirement to pay taxes. UL facilitates introduction of their products into commerce and gives recognition to new and innovative products which may otherwise be questioned in the marketplace. Small businesses capitalize on the UL Certification Mark in competing with the large organizations.

Testimony before the Committee indicating that UL's position is not beneficial to the United States small businesses does not reflect the views of the small business community. A very small segment of the small business community - certain profit-making laboratories, who also qualify as small businesses - sees a certain financial opportunity in diminishing the stature of UL and has attempted to portray UL as another non-profit institution encroaching on small business. Nothing could be further from the truth. Instead, in almost every instance, the opposite is true.

UL's work is needed, supported and appreciated by small business. It is a fact that UL's tax exemption, which permits it to assume the responsibilities required by its role in the safety system in the United States, is supported by thousands of companies in the business community who understand and use UL's services. Many have expressed their support for UL to members of Congress; not only individual companies but also trade associations whose members are predominately small businesses.

UL is not engaged in "unfair competition." Because of the need to carry out the previously stated non-income producing activities as part of UL's product safety certification, UL must generate income from the engineering and follow-up inspection areas to support these non-income activities. Laboratories which do not provide all of the services are free of those costs.

UL's Tax-Exempt Status has Been a Contributor to its Ability to Develop Resources (Including Facilities and Instrumentation) Required to Meet the Demands of High Technology and to Maintain UL's Role as a Viable Institution

As new and innovative products are developed, special facilities and instrumentation are needed to properly establish the safety performance of such products. UL has been called upon to assess the potential hazards of computer and business equipment, medical equipment, communication products, as well as to determine the safety reliability of electronics in many existing products. Approximately 12,000 different types of products are Listed by UL, based on its own standards.

The Federal Government is Relieved of Significant Expense by UL's Assumption of Essential Safety Functions

A number of functions of the type carried out in whole or in part by UL are, in other countries, totally or partially financed or totally assumed by the national government. For example:

- Development and publication of national safety standards
- Development of installation codes (building, structural, electrical, etc.)
- Staff participation in international standards committees
- Conduct of safety research
- Harmonization of national with international standards
- Development of international programs to reduce or eliminate trade barriers in the form of safety requirements and acceptance of test data
- Education of consumers and users in public safety matters

If the U.S. Government were to absorb the cost of these activities, as is done in many other countries, it would substantially exceed the revenue that may accrue to the government by taxing the net income of UL.

Additionally, considerable assistance is provided at no cost by UL's safety experts to the Occupational Safety and Health Administration, U.S. Consumer Product Safety Commission, Department of Defense, General Services Administration, U.S. Coast Guard, U.S. Trade Representative's Office, and other federal agencies. The Federal Government and the public are benefited by the existing wise policy of exempting "Testing for Public Safety" organizations.

Providing this assistance to the Federal Government has been a long-standing policy of UL. UL has treated this policy as an obligation resulting from the unique role it plays in the U.S. safety system.

Support for UL's Position

UL uses the "Testing for Public Safety" exemption well. Many organizations are directly assisted by UL staff involvement, technical expertise and safety research, including agencies of the Federal Government, state and local officials, academia, professional groups, consumers and industry. This assistance is expected of UL as part of UL's product safety certification responsibilities and it is provided unstintingly without cost in accordance with our public safety mission.

In conjunction with the study of the Unrelated Business Income Tax by the Oversight Subcommittee of the House Committee on Ways and Means, letters were sent to Congress by Federal, state and local government officials, by Congressmen themselves, by industry trade associations, by industry members - both large and small, by contractor and labor organizations and by business interests, supporting UL's role and urging that it not be diminished. For your reference, a listing is attached of the cross-section of organizations and individuals who have expressed their support for UL to Congress. UL is confident that the number of letters could be two hundred or two thousand if additional proof is needed of UL's interrelationship with, and support by, others who make up the U.S. safety system.

Conclusion

The matter of UL's tax status has been considered by many individuals and organizations during the study by the Oversight Subcommittee of the House Ways and Means Committee. In addition to the Congressmen on the Subcommittee, and other Congressmen and their staffs, the issue and testimonies and written material were considered by the Treasury Department, the IRS, the Joint Committee on Taxation, the Oversight Subcommittee staff and others. As of this writing, the report of the Subcommittee has not been issued but indications are that UL's tax exemption for "testing for public safety" will be maintained.

We believe there is agreement that the elimination of UL's tax-exempt status would be a grievous error. The tax burden on UL would lead to a reduction in UL's scope of activity, particularly the many activities which are non-income generating. It would impede UL's ability to respond to the need for safety evaluation of new and innovative products. A likely result would be to transfer the burden to the Federal Government, which would lead to increased costs to be borne by government and society as a whole. If UL's activities are curtailed, there will be a reduction in safety levels enjoyed in the U.S. today. This translates to human suffering, more lives and property lost, and more injuries.

July 15, 1988

LETTERS FROM ORGANIZATIONS SUPPORTING UNDERWRITERS LABORATORIES, INC. AND "TESTING FOR PUBLIC SAFETY"

1. U.S. Consumer Products Safety Commission (CPSC)
2. U.S. Coast Guard
3. Office of the United States Trade Representative
4. State of North Carolina, Department of Insurance
5. National Fire Protection Association (NFPA)
6. International Association of Electrical Inspectors (IAEI)
7. Council of American Building Officials
8. University of Maryland, College of Engineering, Fire Protection Engineering
9. Society of Fire Protection Engineers
10. National Electrical Manufacturers Association (NEMA)
11. The St. Paul Companies, Inc.
12. Jasper S. Hawkins, F.A.I.A.
13. Leviton Manufacturing Company, Inc.
14. Cooper Industries
15. Crouse-Hinds Electrical Construction Materials
16. Square D Company
17. Pass & Seymour
18. E.I. Du Pont de Nemours & Company
19. Woodhead Industries Inc.
20. International Brotherhood of Electrical Workers
21. Independent Electrical Contractors Inc.
22. Appleton Electric Company
23. Littelfuse Tracor
24. American Home Lighting Institute

25. Building Officials and Code Administrators International, Inc.

26. Rohm and Haas Company

27. Association of HOme Appliance Manufacturers

28. Furnas Electric Company

29. J. C. Penney Company, Inc.

30. Challenger Electrical Equipment Corp.

31. National Electrical Contractors Association

32. State of Washington - Department of Labor and Industries

33. The City of New York - Department of Buildings

34. State of Oregon - Building Codes Agency

35. Don Von Raesfeld - Former City Manager of Santa Clara, CA

36. The New York Board of Fire Underwriters

37. The Allied Companies

38. National Council of Negro Women, Inc.

39. The Honorable John Porter - Congressman from 10th District, Illinois

40. The Honorable Norman Mineta - Congressman from 13th District, California

41. The Honorable David Price - Congressman from 4th District, North Carolina

TESTIMONY OF
DOUGLAS E. VAN HOUWELING
VICE PROVOST FOR INFORMATION TECHNOLOGY
THE UNIVERSITY OF MICHIGAN
BEFORE THE
COMMITTEE ON SMALL BUSINESS
OF THE
UNITED STATES HOUSE OF REPRESENTATIVES
CHICAGO, ILLINOIS
OCTOBER 1, 1988

Mr. Chairman, Members of the Committee, and Staff:

I am pleased to be here today to have the opportunity to discuss with you the issue of computer sales on University campuses. I speak to you from the vantage point of one who grapples with the complexities of providing information technology for one of our nation's premier public universities. Before joining the University of Michigan, I was responsible for computing leadership at Cornell University and Carnegie-Mellon University. I serve on the Board of EDUCOM, a national non-profit organization of over 550 colleges and universities, whose mission is part of the overall effort to advance and improve the quality of higher education through the use of information technology. Finally, I am a member of the Higher Education and Technology Committee of the National Association of State Universities and Land Grant Colleges. Within that context I will address the computer sales program at the University of Michigan including the issue of competition with local small business firms. I will also discuss the broader issue of university computer sales and the application of the Unrelated Business Income Tax on those sales, as requested.

The University of Michigan has made and is continuing to make a substantial investment in computing and communications facilities that support its students, faculty and staff. The investment includes three of IBM's largest computers (valued at more than $30 million) and network linkages to supercomputers across the nation. The University has also made a major commitment to data and voice communications, with a campus network investment of more than $40 million. The Ann Arbor campus is also the site of the network operations center for the National Science Foundation backbone network, and the MERIT computer network which serves the State of Michigan. The University is also a member of CICNET, a developing network that interconnects the Big Ten universities and the University of Chicago.

In support of the University's 46,000 students, 3,600 faculty, and 20,200 staff, more than 1,000 staff operate facilities, provide support, user education, and other types of assistance needed to effectively utilize the resources. Every member of the community can gain an account on the University's computer system by simply requesting it, and there are more than 83,000 of those accounts in use. Every student at the University pays an Information Technology Access Fee each semester, and the University's general fund provides more than $25 million per year in additional support for the operation of these facilities and services. The University's goal is to infuse the curriculum, research, and administration with the highest appropriate level of information technology.

Personal computer workstations play the crucial role of providing our faculty, students, and staff access to this technological infrastructure. The University has deployed more than 2,000 personal computers across the campus in public clusters, all of which are connected to the network. University departments and individuals have purchased thousands of additional personal computers for their dedicated use. The personal computer is the gateway which allows the individual to take advantage of the University's overall investment.

The University of Michigan's personal computer sales program is a response to those students, faculty, and staff who need dedicated access to a personal computer. The University began its practise of computer sales through the Apple University Consortium arrangement in 1983. Apple's policy at that time was to provide its lowest pricing only to universities that participated in the program, which requires the institution to undertake the sales and support activity. Since that time, a number of manufacturers have offered similar programs, and the University has participated with the primary objective of increasing the number of personal computers owned by its students, faculty, and staff.

Over the past four years, the University has assisted its students, staff, and faculty in acquiring personal computing equipment with a total retail value of more than $40 million. That personal investment is a key component of the University's ability to take advantage of modern information technology, and has a direct positive impact on the teaching, research, and administrative functions of the University. Between September 1986 and July 1988, individuals purchased 5,550 machines. More than two thirds (3,703) went to students, one sixth (912) went to teaching and research faculty and staff, one eighth (682) went to management, professional, and medical staff, and only 4% went to clerical or trades employees (253). There is no evidence that these machines are being purchased for other than personal, university-related use. All purchasers must be either full-time students or full-time employees of the University, must not have purchased a personal computer from the University during the two previous years, and sign a pledge that the equipment will not be sold or leased for two years after purchase.[1] These conditions are required not only by the University's sense of its appropriate role, but also by the manufacturers supplying the equipment.

The University works closely with the major United States manufacturers to arrange the terms and conditions, and obtains total discounts which enable volume pricing at about 50% discount from list. These prices are carefully calculated and audited to recover the total costs of the program, including space, staff, and support costs. The University does not make a profit and has no related tax liability on the Unrelated Business Income Tax return it files annually.

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[1] The actual pledge signed by each purchaser reads, "I hereby certify that , as of Fall Term 1988, I will be (either) a full-time student of The University of Michigan, (or) a full-time regular employee of The University of Michigan having a 100% appointment (40 hours per week) and that I am eligible to receive all staff benefits. I further certify that this equipment and software is for my own personal use and possession, and will not be sold, leased or otherwise disposed of for at least two (2) years. Violation of this condition will subject me to payment of liquidated damages to the University of $2,000. I may receive questionnaires and other inquiries about the use of my computer from time to time, and I am willing to respond. I have not purchased a microcomputer from the University within the two (2) year period prior to the date of this order. I understand that if it is determined that I am ineligible, the University will retain $20 to cover the cost of processing this order." The University uses its own records to verify these claims before actually filling the order.

The vendors with products in this Fall's sale are Apple, Citizen, Claris, Hewlett Packard IBM, Microsoft, and Zenith. Our criteria for selection of a manufacturer include after-sale support, compatibility with the major personal computing standard software, stability and longevity of the company, and willingness to work with the University in achieving the University's overall information technology objectives. These criteria not only reduce the University's costs for support of the products, but also insure the minimum possible depreciation on each individual's investment.

The University of Michigan has maintained a continuing dialogue with the authorized dealers of the products offered by the University, and has worked with the dealers to develop steadily more cooperative arrangements for the sale and support of machines. We have developed a system for our regular sales throughout the year that provides dealers the ability to resell computers purchased at the University's very favorable cost, and we price those computers at a level which allows dealers to recover not only their out-of-pocket sales and handling costs, but also their share of the before and after-sale support costs. As a result of this policy, students, faculty, and staff are able to routinely purchase a machine from any of the participating dealers for the same price as that available from the University.

Once every year, the University sponsors a major sales event for students, faculty, and staff. This event is also carried out in conjunction with the authorized dealers in Ann Arbor who wish to participate. The dealers are provided with space at the event to sell accessories, supplies, and software. The dealers are also provided financial support to defray the costs they may incur as providers of before and after-sale support to the purchasers. This year all authorized dealers are participating in the sale, and our orders to date indicate that about 3,000 personal computers will be purchased at the event. It is very clear to the University and the participating dealers that no other approach to sales would result in such a large volume of purchase.

The large volume of computers in University offices and the homes of students, staff, and faculty clearly creates a large demand for dealer-provided products over the life of those machines. Ann Arbor, a city of about 100,000, including the students, has approximately 45 small retail businesses providing equipment, software, and supplies for personal computers. The number of such businesses continues to grow, and none of the major firms have ceased business. By almost any measure, the University's promotion of personal computing in Ann Arbor has been good for small business, even in the short run. The large population of computer consuming graduates this program generates will provide a rapidly increasing demand for similar services far into the future, both in the Ann Arbor region and throughout the nation.

This year's major sales event, "Computer Kickoff '88", will be held on October 14th and 15th in Ann Arbor. It is truly a remarkable cooperative effort, resulting in the distribution of thousands of computers in a two-day period. If any of you would like to see how it operates and talk directly with the people involved, I would be delighted to host your visit to the event.

An example of the University's efforts to work with one of our local businesses is the history of our relationship with Technology Partners and its subsidiary, Todays Computers Business Center. Technology Partners has a record of high quality support for the University, and has therefore enjoyed the largest volume of business with the University of any of the local dealers. In fiscal year 1986-87, Technology Partners sold $605,709 worth of computing equipment, software,and supplies to the University directly with an unknown additional volume directly to individuals associated with the University. The comparable figure for the 87-88 fiscal year are $506,453. These figures are down substantially from earlier ones because of the adverse impact of a October 14, 1986 memorandum from Technology Partners to University of Michigan departments announcing, "Effective 11/1/86 we will no longer be selling computer peripheral products to University of Michigan departments." Fortunately for all, Technology Partners has not rigidly enforced its policy. Technology Partners will be offering a variety of products at this year's Computer Kickoff. Furthermore, as we have continued to work with Technology Partners, we have attempted to become more sensitive to their concerns. On September 23, the owner of Technology Partners congratulated the University for the approach it took on a printer bid.

There has been some continuing concern regarding the University's overall purchasing practices which have led to University support being given primarily to US-made products from major vendors. While the University could obtain lower prices in the short-term from some of the smaller "clone" manufacturers, it has rather chosen to develop the strongest possible relationships with the most stable and dominant firms in the marketplace. Through careful compliance with the University's purchasing guidelines and extensive negotiation, this policy has yielded pricing competitive with the alternatives, and has almost certainly minimized confusion and life-cycle costs to the purchasers. The major software vendors are careful to maintain their products' compatibility with the equipment from these major manufactures. Sticking with the industry leaders has protected the investments of the students, faculty, and staff, and has reduced the costs to the University for constantly testing and certifying the compatibility of the enormous array of products constantly emerging and disappearing from the marketplace.

As we broaden our view beyond the University of Michigan and Ann Arbor, I believe it is appropriate to include a number of issues and activities now under consideration by the Congress. Fundamentally, the issue is one of balancing the value of information technology use in higher education against concerns of unfair competition with small business. I would like to review this issue from four perspectives -- higher education, computing manufacturers, computer retailers, and the national interest.

Higher Education

The higher education community is remarkable in its pluralism and decentralization. The resulting freedom of inquiry and multiple options for research and education have contributed to making higher education in the United States the best in the world. The community consists of students, faculty, staff, and, of course, the institutions themselves.

A recent issue of INFOWORLD contains a full page article headlined "Students Play Key Role in Technology Revolution." The article goes on to say, "...even with rising campus purchases, student resale programs are a key factor in many institutional efforts to increase computing capacity."[2] Over a quarter of the entering freshmen were frequent users of a personal computer, and more than half had a computer class in high school. College students increasingly view computers as a key to their individual productivity, and faculty are increasingly assigning work in quantities and of types that assume these high levels of personal productivity. Furthermore, every forecast predicts an increasing use of information technology in the future, and students familiar with its utility will be more competitive and contribute more to the society. Most college students face considerable financial challenges, and the ability to obtain a personal computer at about half price often means the difference between acquiring a computer and doing without.

The faculty are a crucial link. Faculty are less a part of the "computer age", but need to move rapidly into it simply to meet student expectations. Furthermore, as we expand the demands on faculty to do more research and to participate more extensively in the economic and social development of their communities, they also face a very real need for improved productivity. Faculty do much of their work at home as well as in their offices, and quite often have two personal computers, one they purchase for home use, and one the university purchases for office use. Faculty are also ideally positioned to innovate in software for personal computers, and those innovations are important not only to higher education, but also to the computing industry as a whole. Faculty salaries have historically been below salaries for individuals with similar education and background in other parts of society, so they to are often unable to afford adequate personal computing facilities at full prices.

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[2] Kenneth C. Green,"Students Play Key Role in Technology Revolution", INFOWORLD, September 26, 1988, Page S10.

There has been much discussion regarding the appropriateness of including staff in higher education personal computer sales programs. Much of that discussion has failed to consider the role of staff in the college and university setting. First of all, a very large proportion of the staff is engaged in research and professional support. That staff interacts directly with the students and faculty to facilitate the accomplishment of the school's educational and research goals. For instance, at the University of Michigan, all of our nearly 400 residence hall counselors are provided with personal computers to enable them to more effectively communicate with students, faculty, and staff using electronic mail. We have approximately 1,000 employees who are professionals working directly in the information technology support units of the University. In all of these cases and many like them, staff require personal computers to do their jobs, and can be much more productive by acquiring a personal unit to support their work outside the office. In the relatively informal structure of a college or university, staff need full access to information technology simply to stay in touch with the people they support, and our data show that such staff investment pays off for the institution as a whole.

Universities and colleges confront a serious challenge in their ability to respond to the promise of information technology. While their students expect a technologically advanced environment in which to work, and faculty and staff require access to modern information technology to be competitive with colleagues at other institutions, they cannot point to additional profits as a "bottom line" justification for increased investment. Indeed, most institutions of higher education are under substantial pressure to reduce expense. Furthermore, a good information technology environment requires much more than personal computers. Mainframes and supercomputers, networks, and staff support are all critical to realizing the potential of the personal computing revolution. Expenses for this infrastructure exceed the cost of the personal computers themselves, and have to be funded through the institutional budget. As a result, many universities and colleges depend on substantial individual investments to fill out their information technology portfolio, and those individual investments have been almost exclusively been limited to items of personal property such as personal computers and software.

For the whole system to perform adequately, though, the individual purchases must be compatible with the institution's overall infrastructure. The institutional leadership can encourage such compatibility by selling machines which conform to standards. In summary, the capability to sell personal computing equipment at substantial price reduction has become vital to the productivity and technological progress of higher education.

Computing Manufacturers

The manufacturers of computing equipment and software also strongly benefit from higher education sales programs. Most important, such programs stimulate sales to precisely the population segment most likely to find information technology useful throughout their careers. Every student purchasing a machine is likely to purchase several more over a lifetime, and to encourage their children to use the technology. Almost equally important is the fact that many of the innovations in personal computing have come from students, faculty, and staff in higher education. The first spreadsheet program grew out of a class assignment. The industry depends on the higher education community as a source for innovation and employees. In most cases, manufacturers also require the institution to provide on-campus support for their products. That support greatly reduces the cost of serving an individual customer and provides a focal point for interaction with the institution. It also allows the deployment of the most advanced tools for testing and evaluation in an environment somewhat more "fault-tolerant" than the business community. The manufacturers have created direct sales channels to higher education because it provides them with direct benefit, not just because they wish to be supportive of education.

Computer Retailers

Only the most short-sighted view would lead to the conclusion that direct higher education sales programs are inimical to the interests of computer retailers. The long term benefits of cooperation between retailers and the college or university greatly exceed the costs to the retailer. First, the institution is in a position to generate a far larger volume of business than are the competing retailers. Part of that volume results from favorable pricing, but much of it stems from the ability of the institution to communicate with potential users, motivate their purchases, and link their systems into an institution-wide structure. Furthermore, the university possesses the staff and business facilities to manage this volume, while a small business would be hard-pressed.

Though the actual purchases are restricted to members of the university or college community, there are still many opportunities to see what personal computers can do, thus purchases from outside the higher education community are stimulated. Once the volume is stimulated, of course, the retailer has countless opportunities to profit from aftermarket purchases of software, supplies, and ancillary equipment to individuals in and out of the higher education community. Over time, the nation-wide stimulus of higher education's commitment to personal computing technology accelerates business for the retail computing industry.

Retail dealers who question higher education's role in direct sales often think of the profits they could make assuming that they would be able to themselves generate the volume of business present in their community. What they often fail to recognize is that volume would not exist if the colleges and universities had not stimulated it in the first place, and would rapidly decline without the impetus of the direct sale program. The facts are that college and university towns are favorable to retail dealerships and therefore tend to have comparatively large numbers of strong dealers. Self-interested small businesses seek out such locations and build cooperative relationships with higher education.

National Interests

Ultimately, though, this committee has to make its judgement not so much on the costs or benefits to any one segment of the society, but on the basis of the national interest. The United States has the world's strongest computing industry, and that industry has grown out of close cooperation between our higher education system and industry. The future competitiveness of our nation will depend on its ability to use and process information, just as in the past our strength has depended on our ability to use and process materials. The personal computer and the infrastructure supporting it will be critical to our ability to become the world's leading information-based nation. Our system of higher education not only provides the people who must invent that future, but also much of the innovation and research that will undergird it.

The quality of the information technology environment in our system of higher education has been built, in part, by the cooperation between higher education and computer manufacturers, which includes the direct sales program to the university community. This current pattern of market arrangements is only a few years old, and is still evolving in response to the needs of all parties. This committee should recognize the benefits and the steadily improving cooperative relationships that have resulted from these arrangements . While a stong Federal role is needed in many areas of information technology and higher education such as national networking and supercomputing, the current environment for the marketing of personal computing systems to higher education is evolving well enough to avoid the need for corrective legislation.

A large computer-capable population will become increasingly important to education, computer industry, small business, and the nation. The current marketplace for personal computers in higher education serves all of those interests. While it may not be perfect in the short run, it is steadily evolving and is in the national interest. Mr. Chairman, that concludes my remarks. I would be happy to entertain any questions the committee might have.

TESTIMONY ON BEHALF OF
THE YMCA OF THE USA
BEFORE THE COMMITTEE ON SMALL BUSINESS
UNITED STATES HOUSE OF REPRESENTATIVES

CHICAGO, ILLINOIS

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PRESENTED BY

JOHN W. CASEY

PRESIDENT

YMCA OF METROPOLITAN CHICAGO

Mr. Chairman, Members of the Committee, my name is John W. Casey and I am the President of the Y.M.C.A. of Metropolitan Chicago. The Y.M.C.A. was founded in Chicago in 1858 and we are now in our 130th year of continuous service to the residents of Metropolitan Chicago.

The Y.M.C.A. is a voluntary organization owned and directed by community volunteers who serve without monetary compensation or economic interest. In total, we have almost two thousand volunteer citizens who give of their time, resources and commitment to carry on the mission and purpose of the Y.M.C.A. Almost all of those individuals come from the small business community and each organizes other small business men and women to assist and support the Y.M.C.A. We have a very close relationship to small businesses and support the efforts of this committee to protect and strengthen the small business community.

The Y.M.C.A. of Metropolitan Chicago is one of the oldest and largest Y.M.C.A. Associations in the country. We serve over 350,000 people per year in a wide range of programs and activities for people of all ages - 6 months to 85 years of age. We serve them through 25 local community branches - 18 in the City and 7 in the suburbs - and in addition we operate 6 resident camps for children and families, and a variety of other programs serving people with special needs - unemployed, drug abusing youth, handicapped and elderly shut-ins, to give a few examples. Of the 18 branches in the City - 14 are located in inner-city neighborhoods.

We manage over 25 community facilities across Metropolitan Chicago. The average age of our branch facilities in Chicago is about 60 years and overall our buildings average over 50 years of age. We opened a new Y.M.C.A. in the near north side of Chicago in 1981 - prior to that our newest facility was a suburban Y.M.C.A. opened in 1969. We recently broke ground for a new Y.M.C.A.

facility in the Woodlawn Community on Chicago's South Side. Other than that, our current 5 year strategic plan is committed to re-investment in older facilities with the total focus being on our neighborhood Y.M.C.A.s. One example of this is our single room occupancy housing. In the past 5 years, Chicago has lost 50% of its SRO housing stock leaving just 11,000 such rooms available City-wide. The Y.M.C.A. continues to operate 1,765 SRO rooms or 17% of the remaining housing stock. This housing is inhabited by our very marginal, low income people who quite literally have no place else to live. We are currently raising funds to remodel and upgrade that housing for the long haul because it is projected that the City will lose an additional 1,000 units per year over the next 5 years. All of our housing is in community Y.M.C.A. buildings.

We in the Chicago Y.M.C.A. are very proud of the great diversity of our Association and our commitment to the people and communities that we serve. Allow me to provide a few facts based on our performance in 1987:

- we provided scholarships for approximately 10,000 needy kids and adults who otherwise could not participate. Nobody is denied access to a Chicago Y.M.C.A. because of ability to pay.

- we involved 86,000 people in family life programs aimed at strengthening family relations.

- we administered day care programs for 2,084 children and elderly adults.

- we provided job training and placement to 1,360 unemployed and underemployed citizens. That alone saved taxpayers over $10 million dollars in AFDC, Food Stamp, and other benefits they would have otherwise received.

- we enrolled 2,339 young people in leadership development programs including Youth and Government.

- we assisted at their homes, 467 homebound physically handicapped and seniors who otherwise might be institutionalized.

- we provided counseling and emergency services, special programs and therapy for 14,000 troubled youth, families, parents and spouses.

- we provided special classes for the handicapped, the arthritic, and stroke patients.

- we involved approximately 4,523 volunteers who assisted Y staff in our work with youth.

- we enrolled 190,000 people in our time honored physical education programs, including swimming, aerobics, health and fitness, pre and post natal fitness, and sports.

- we offered camping experience to 3,111 children - many of whom attended free of charge.

and finally,

- we provided free or reduced fees for those with a demonstrated need -- without regard to race, color, religion, sex, national origin, age, or physical or mental handicap.

In the early 1900's the Chicago Y.M.C.A. - through its mission and goals, committed ourselvés to being a pioneer and leader in the area of physical education and physical fitness. From then until now we have been viewed as the primary community institution concerned with the prevention of obesity and cardio vascular diseases. One of the first neighborhood Y.M.C.A.s built in Chicago in 1908 - had a major emphasis on physical education and physical fitness - the Sears Y.M.C.A. in the Lawndale community. That same Sears Y.M.C.A. - today - eighty years later - is still providing many of those same basic health services in that same 1908 facility.

The mission of our Chicago Y.M.C.A. is to aid in the development of Christian values and to support the physical, mental and spiritual well-being of individuals and families in order to improve their quality of life. To achieve this mission, the Y.M.C.A. through effective board, staff and volunteer leadership, in collaboration with other community institutions, provides quality programs which enhance human and community growth and development.

For over a century this mission has served as the underlying policy rationale for Y.M.C.A. involvement in fitness programs - adult or otherwise. I say otherwise because we also have a major program of fitness and aerobic exercise for school aged children. We recognize the physical dimension of quality of life to be equally important as the spiritual and mental dimensions. I think it would be impossible to measure - over the years - the totality of the contribution that the Y.M.C.A. has made in the prevention of diseases. The Chicago Y.M.C.A. alone has served over 10 million people.

Most of our Y.M.C.A. members who participate in fitness programs, also participate in many other Y.M.C.A. activities. Most of them are part of families - unlike health clubs who cater only to adults. They participate in a broad range of family programs. Many others offer their services to us as volunteers and help supervise youth programs and sports leagues. Our environment encourages giving and caring for others.

Let me use a recent example of the Rich Port Y.M.C.A. in suburban LaGrange, Illinois - part of our Chicago Association. This Y.M.C.A. has a number of handball/racquetball courts in the building. They have been there for 35 years. Recently, a group of handball playing members approached the Y.M.C.A. with an idea for constructing outdoor courts. They felt that handball as an activity would be a great way to get the whole family involved both as spectators and participants. If it were outdoors, everyone would have access to the courts and everyone would be able to observe the play.

Two weeks ago construction was finished on these outdoor courts, which incidentally have been built on park district land assuring access by Y.M.C.A. members and non-members alike. The $180,000 cost of constructing these courts, which in effect are a gift to the park district, came from contributions donated and solicited by the handball players who had the original idea. Those same players have committed to providing free weekly handball lessons to the young people of the community. That is one example of how the Y.M.C.A. differs from the commercial health and fitness clubs - the involvement of our members in a range of activities that strengthen the family and the community.

We differ in many other ways:

1. We serve the whole community - not just the affluent or the affluent communties. Mr. Schwartz, in contending that the Y.M.C.A. should only serve the poor, unfortunately is fostering an ill conceived and discriminatory concept that separates people by class. If you

are low income and of a lower class then you should go to your own school, your own neighborhood, your own beach, your own section. There is a great new Y.M.C.A. - which cost incidentally $8 million - located less than 5 minutes away from Mr. Schwartz's Mid Town Tennis Club on the near north side of Chicago. It serves equally both the low income, high crime Cabrini Green Housing Projects and the upscale, affluent Lincoln Park section of the neighborhood. We built this Y.M.C.A. as a demonstration of how people can and will come together despite race, class or other differences. This is the Y.M.C.A.'s mission and purpose. There are 7,000 members - 2,000 from Cabrini Green and 5,000 from the surrounding area. Incidentally, this Y.M.C.A. has a very large and successful physical fitness program. This New City Y.M.C.A. serves everyone in the community - provides day care for 300 children, community economic development projects, job training, community run businesses, and a wide range of social service programs. We do, however, also serve the affluent - should we lose our tax exempt status? I would be remiss if I did not thank Mr. Alan Schwartz because he makes an annual contribution to the New City Y.M.C.A.

2. The New City Y.M.C.A. will be in that community for 100 years or more. Will the local health clubs be there in 5 years? The Attorney General of Illinois has a bill pending in the legislature that would require the bonding of health clubs based on reports to his consumer protection division of widespread abuses and shady business practices. He has documented complaints of fitness clubs selling memberships in the morning and declaring bankruptcy in the afternoon. The Wall Street Journal had a recent article detailing

these abuses. There is no record of a single Y.M.C.A. abuse of this nature. We will be there for the long haul and will adapt as the needs of the neighborhood change.

An important event occurred in Illinois last year when the Y.M.C.A.s in Illinois went to our legislature to seek legislative clarification of our not-for-profit status. For the past several years we too have been besieged by press stories, rhetoric and accusations similar to what we hear from Mr. Schwartz today. Our Illinois Constitution is silent in defining charity and some unrelated case law was being used against us.

We went to the legislature in broad daylight; filed a bill that had bi-partisan sponsorship in both houses; went before the Revenue Committee hearings in each house; subjected ourselves to open and complete scrutiny on the part of government and the public; passed each committee without a dissenting vote; passed the Illinois Senate by the vote of 59-0; passed the Illinois House with a vote of 114-0; and was signed into law by the Governor immediately. This new law states that if a Y.M.C.A. has a federal 501-C-3 status and has bylaws that provide accessibility to the Y.M.C.A. regardless of ability to pay, that the State Revenue Department shall not tax the Y.M.C.A. That is how the people at the grass roots of Illinois feel about the Y.M.C.A. and its role in the community.

The concept of "profits" in our capitalist system provides the human incentive that makes our system work. We all support that. However, at no time should profits over-ride the values base of our society. At that base are two important concepts of American life that set us apart from almost every other society. One is the time honored practice of volunteerism that is the energy system of our community. That is when local people, acting without monetary compensation, take it upon themselves to organize institutions that broadly benefit their community. The other is the concept of eleemosynary giving - the charitable practice where the haves of our society help the have nots. Neither require government involvement - and both relieve considerably, potential burdens on government. For example, our country is on the brink of a health care crisis. How much worse would it be if the Y.M.C.A. did not have tens of thousands of people in exercise programs every day of the week. That alone could earn us our tax exemption.

Despite the fact that we have lost members as a result of the so called fitness craze and the subsequent proliferation of health clubs, the Y.M.C.A. supports the expansion of the fitness business - particularly in the hands of reputable owners and operators such as Alan Schwartz. After all we invented the games of basketball and volleyball and don't whine when superstars get paid $25 million contracts. Basketball is good for the community. We are proud that we pioneered, and are recognized as such by the Surgeon General, these important health fitness programs. We don't think we should be punished for that.

Income and property taxation of Y.M.C.A.s is, in our judgment, not good public policy - it is not in the best interests of the larger community. Leasehold taxes, user fees and some other service taxes many times are reasonable and should be paid by the Y.M.C.A. I believe that the government, in a quest for short term revenues or profits that benefit a few, can undermine and jeopardize the wellbeing of the traditional voluntary values of our society.

In 1939, a Chicago hotel sued the Chicago Y.M.C.A. for unfair competition to their hotel rooms. In a very clear and thoughtful decision, the Illinois

Supreme Court ruled in favor of the Y.M.C.A. and developed a scholarly definition of charity that prevails today. Their wisdom stood the test of the years and here today - those same Y.M.C.A. residence rooms stand as one of the last available sources of affordable housing for almost 2,000 low income citizens of Chicago. None of the hotels are still in business - but if they were they would not have adapted as we did. They were in business to make money - we are in business to serve the community.

Our new Y.M.C.A. in Woodlawn will primarily serve a black membership base. Hypertension and stress related diseases are shown by all research to impact the black community at 7 to 10 times the rate of the white middle class community. The preventive health programs that we will conduct at the new Southside Y.M.C.A. will save the lives of black professionals and business people. Mr. Schwartz suggests that we serve only the poor. Who then will serve the others? Are health clubs only interested in downtown and the affluent suburbs? This new Y.M.C.A. has made a public commitment to provide 1,500 scholarships to low income community residents in addition to serving the more affluent.

We are interested in the suburbs too. Although life may be more affluent in those communities, our Y.M.C.A. mission does not judge people by their salaries. Everyone knows that family life is under as much pressure in the suburbs as it is in the City. Drug abuse, mental health problems, alcohol abuse, child abuse, incidents of battered spouses, lonely elderly, and growing suburban poverty are becoming just as acute. Those communities need and deserve a Y.M.C.A. too. Most people in the suburbs are not rich. Those who are tend not to join Y.M.C.A.s - but prefer country clubs. Just because they have achieved a certain income level should they be deprived of tax exempt, not-for-profit institutions that help their families? After all, they built these institutions and have prevented an additional burden on government for having done so.

I believe that Mr. Schwartz is confusing the issues and is misinformed about the purpose and mission of the Y.M.C.A. Health Clubs are in a different business than Y.M.C.A.s and Jewish Community Centers and exist for a different purpose. Our Chicago Y.M.C.A.s are no different than most other Y.M.C.A.s in the United States. We are very typical. If health clubs provided a quality program, were managed properly and weeded out unscrupulous operators they would co-exist with Y.M.C.A.s in the community and the whole community would benefit.

I will conclude by briefly addressing one last issue - the Y.M.C.A.'s position on the June 23, 1988 draft proposal of the Oversight Subcommittee of the House Ways and Means Committee regarding unrelated business income tax.

The report recommended that income derived by Y.M.C.A.s and other charitable organizations from fitness, exercise and similar health promotion activities should be tax exempt if:

> "The facility at which the activity is conducted independently serves a primarily charitable purpose. The required charitable purpose could be demonstrated by various factors, such as ... providing service to the community as a whole."

The Subcommittee has made clear that this proposal is intended to preserve the "community affordability" test that the IRS has applied to Y.M.C.A. fitness activities since 1984. Under this test, a Y.M.C.A. must demonstrate that each fitness facility, and, indeed, each membership category within a fitness facility, serves a broad cross-section of the income and occupational groups in the community.

Y.M.C.A.s are committed to this principle of "community affordability" in all aspects of our program, and, therefore, fully support continued application of this standard for purposes of unrelated business income tax. IRS experience since 1984 demonstrates that this "community affordability" test is practical and administrable. Further, the "community affordability" test reflects one of the fundamental differences between Y.M.C.A.s and commercial health clubs -- the fact that Y.M.C.A.s serve all persons in the community, not just those who can be served at a profit. The "community affordability" test also recognizes the strong public interest in increasing the availability of quality fitness programs to all persons, not just the poor.

I thank you for the opportunity to address the Committee and would be happy to try to answer any questions that you may have.

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